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DEPARTMENT OF LABOR'S ENFORCEMENT OF THE EMPLOYEE RETIREMENT INCOME SECURITY ACT [ERISA]

HEARINGS

BEFORE THE

SUBCOMMITTEE ON
OVERSIGHT OF GOVERNMENT MANAGEMENT

OF THE

COMMITTEE ON
GOVERNMENTAL AFFAIRS
UNITED STATES SENATE

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DEPARTMENT OF LABOR'S ENFORCEMENT OF THE EMPLOYEE RETIREMENT INCOME SECURITY ACT [ERISA]

TUESDAY, JUNE 25, 1985

U.S. Senate,
Subcommittee on Oversight
of Government Management,
Committee on Governmental Affairs,
Washington, DC.

The subcommittee met at 9:35 a.m. in room SD-342 of the Dirksen Senate Office Building, Hon. William S. Cohen (chairman of the subcommittee) presiding.

Present: Senator Cohen.

Staff present: Susan M. Collins, staff director; Mary B. Gerwin, counsel; Kim Corthell, professional staff member; Linda J. Gustitus, minority staff director; Frankie de Vergie, chief clerk; and Rachel Harlan, assistant chief clerk.

OPENING STATEMENT OF SENATOR COHEN

Senator Cohen. The subcommittee will come to order.

On Labor Day 1974, President Ford signed into law the Employee Retirement Income Security Act, now widely known as ERISA. Many factors came together to encourage passage of this landmark legislation. The substantial growth of private pension funds since the 1940's, tragic pension plan failures such as the historic Studebaker case, as well as the 1965 report of the Cabinet Committee on Corporate Pension Funds, convinced the Congress that legislation was necessary to insure that the pensions of workers would be there when they retired.

After almost 10 years of deliberation, Congress passed ERISA to demonstrate its commitment to the rights of individuals covered by private pension plan employee benefits plans. The act, the most comprehensive employee benefits law ever enacted in the United States, establishes minimum standards for private pension plans in such areas as vesting, participation, and plan funding. It also places reporting and disclosure requirements on plans and establishes basic standards for plan fiduciaries to meet in fulfilling their responsibilities to workers and retirees.

Other significant provisions of the pension act provide Federal insurance to guarantee the payment of the pensions, in the event that the plan terminates without sufficient funds to pay its promised benefits.

The Congress gave three Federal agencies jurisdiction to administer this complex pension and benefits law: The Department of Labor, the Internal Revenue Service, and the Pension Benefit Guarantee Corporation.

Today this subcommittee is going to focus on the Department of Labor which administers key provisions of ERISA designed to protect the interests of employees, such as the reporting and disclosure requirements. The Department of Labor also has the authority to interpret and enforce the fiduciary duty and prohibited transaction rules set forth in the act.

These provisions of ERISA are intended to insure that pension funds are handled in a manner that is solely in the interest of the plan participants and beneficiaries, and that employers and workers know their rights and obligations under the law.

Over the past few years, the Department of Labor's implementation of ERISA with regard to pension plans has been criticized repeatedly for being ineffective. Several different groups, including the General Accounting Office, the Department of Labor's inspector general and the Permanent Subcommittee on Investigations, have concluded that the Department's enforcement of ERISA is inadequate.

A frequent criticism is that the Department should make better use of the annual reports filed by the pension plans.

Last year an enforcement task force within the Department of Labor itself found that the Department has been "Unable to maintain credibility sufficient to create an impression within the employee benefit plan community that violations are likely to be detected and corrected."

Critics also maintain that the Department's processing of prohibited transaction exemptions is unduly slow, resulting in lost investment opportunities for some plans. Possible remedies for this problem include changing the standard in the law or creating a new mechanism outside of the Department to handle applications for exemptions. Other experts, however, caution that revising the prohibited transactions rules or procedures could lead to the very abuses ERISA was designed to prevent.

Many observers believe that the Department of Labor has given low priority to the entire ERISA Program, leaving the pension office understaffed, underbudgeted, and ill-equipped to effectively enforce the law. These hearings will provide an opportunity for the subcommittee to evaluate these and other concerns.

Today and tomorrow, the subcommittee is also going to examine the Department of Labor's implementation of the fiduciary duties under ERISA in the corporate governance area. Due to the phenomenon of pension funds emerging as influential institutional investors, there has been increasing discussion over what responsibilities ERISA imposes on pension plan fiduciaries in corporate governance issues, such as voting stock held by pension funds and the use of pension funds, offensively and defensively, in corporate takeovers. Concerns have also been raised over the conflicts of interest faced by some plan sponsors, trustees, and investment managers in making decisions in behalf of pension funds.

As the pension office concluded in its report summarizing its public hearings that were held earlier this year in New York and

San Francisco: "The picture, then, is one of a statute that is not understood, and that contains internal contradictions; unprecedented asset pools; professional service providers responsible for compartmentalized duties; no special reward for superior performance and perceived strict accountability for deficiencies; no oversight for the system as a whole; no statistical basis for comparing the costs and benefits of the system; no differentiation between the desirability of savings and pensions."

That reminds me a little bit of that British diplomat during World War II who wired back to his home office: "It's impossible for me to exaggerate the gravity of the circumstances, but I'll try."

The quality of DOL's implementation of ERISA, both in traditional enforcement and corporate governance areas, is especially important in light of the large number of pension plans, participants and beneficiaries, and plan assets that are now subject to ERISA.

In 1984, over 788,000 private pension plans were subject to ERISA. These pension plans covered over 64 million participants. In addition, according to the Employee Benefit Research Institution, approximately 8.7 million retirees were receiving benefits from private pension plans last year. Although pensions for these millions of Americans are subject to the single law of ERISA, with so many pension funds and pensioners, both current and future, dependent on the protections established by ERISA, it is crucial that the Congress ensure that the Department of Labor is adequately overseeing and enforcing the law.

The tremendous growth in assets held by pension funds over the past decade further illustrates the need to ensure compliance with ERISA. In 1984, the assets held by pension funds exceeded $1 trillion, of which some $400 billion were held in equities. If the current trends continue, the assets of private pension funds will reach $2.4 trillion by the end of the century and pension plan ownership of common stock in publicly traded corporations may exceed 50 percent by the year 2000. With such huge stakes involved, there is increasing debate over what role the Department of Labor should play in monitoring and guiding the voting and investment decisions of fiduciaries to these pension plans.

In these 2 days of hearings, the subcommittee is going to hear a variety of views on the issues. Today, we are pleased to have as our first panel three of the former administrators of the Department of Labor's Office of Pension and Welfare Benefit Programs. As former heads of the pension office, they can provide unique perspectives on the adequacy of the ERISA Program within the Department. We are also going to hear from Michael Gordon who, as pension counsel to Senator Javits during the passage of ERISA, can provide some insight as to what was intended by the original authors of the law.

Tomorrow, we are going to continue our hearing with testimony from the Department of Labor and several private sector witnesses.

Finally, I would mention that I have discussed these oversight hearings with Secretary Brock. He assured me of his support for the subcommittee's efforts and indicated that ERISA will be a high priority during his administration. To demonstrate his commitment, Secretary Brock intends to elevate the position of administrator of the OPWBP to a level of assistant secretary when he announces the new head of the office. I'll certainly applaud this tangible evidence of the Secretary's intention to devote greater importance to the enforcement of ERISA.

As I mentioned before, I am pleased to have three former administrators of the Department of Labor's Office of Pension and Welfare Benefit Programs: Robert A.G. Monks, Jeffrey N. Clayton, and Ian D. Lanoff. Mr. Monks is accompanied by Janet Brown, his former special assistant.

Mr. Monks, since you were the head of the pension office most recently, I'd like you to give your statement first, followed by Mr. Clayton and Mr. Lanoff.

Before I begin, I'd like to pay tribute to a tireless trio—Susan Collins, Mary Gerwin, and Kim Corthell of our staff—who have spent literally hours trying to make the inexplicable, explicable to this committee chairman. They've done a really outstanding job.

I see you have many books in front of you, Mr. Monks. I have a comparable amount here. I have been reading them more and more and enjoying them less and less, but with that in mind, why don't you go ahead.

TESTIMONY OF ROBERT A.G. MONKS, ACCOMPANIED BY JANET BROWN, FORMER SPECIAL ASSISTANT; JEFFREY N. CLAYTON AND IAN D. LANOFF, FORMER ADMINISTRATORS, OFFICE OF PENSION AND WELFARE BENEFIT PROGRAMS, DEPARTMENT OF LABOR

Mr. MONKS. Mr. Chairman, my name is Robert Monks. From December 1983 to January 1985, I served as Administrator of the Office of Pension and Welfare Benefit Programs at the U.S. Department of Labor, in shorthand, OPWBP at DOL.

I am delighted to appear before you today and grateful for the subcommittee staff's interest in this subject. I know the hearings you are holding will provide a constructive examination of the enormous growth of private pension plans and the Government's role in overseeing them.

Let me start by saying that I sincerely hope these hearings will serve to assist Secretary Brock and his senior staff in administrating ERISA.

I have great personal and professional admiration for the Secretary, and I know his tenure at the Labor Department will benefit all the programs under his supervision.

Nothing in my oral or written statements should be construed as criticism of the Secretary or his agenda, since I resigned from the Department before his nomination.

All my experience in the pension office occurred in a different Labor Department administration.

I hope the work I undertook last year, which I will discuss today, might be a useful resource for the Secretary and his appointees.

I would also like to note that my comments relate to structural problems. The career staff of the pension office with whom I worked, are absolutely first-rate. They are dedicated able individuals, who, in my opinion, are confronted with an impossible task. The size of the responsibilities, however, has not daunted and has never lessened their sense of commitment or performance. I admire them greatly and know that my successor will be well-served by their expertise.

Let me begin with a brief overview of the Employee Retirement Income Security Act of 1974, commonly known as ERISA. This law governs all private pension plans. Although the creation of a private pension plan is voluntary, if an entity does choose to set one up, it must conform to ERISA guidelines. Chief among these is the designation of a trustee who is responsible for ensuring that pension plan assets are managed exclusively for the benefit of plan participants.

ERISA has encouraged the establishment of more than 900,000 pension plans. Their assets now total approximately $1 trillion, $1,000 billion, the largest single pool of capital in the history of the world. It is estimated that ERISA funds own almost one-third of the equity in publicly traded U.S. corporations and one-half the debt. It is projected that they will own half the equity by the year 2000.

As is evident from these statistics, ERISA's impact is vast. There is no major financial transaction nor any corporate takeover that does not involve ERISA funds. As recent media coverage indicates, people are only beginning to understand the pervasive effect of this huge amount of money. Certainly some of its effects were foreseen by Members of the Congress who drafted the act. Some were not and, indeed, could not have been.

There are at least four major consequences that ERISA sponsors could not have contemplated.

The first of these is the sheer size of pension assets, $1,000 billion, one-third of all the equity in all listed U.S. corporations. Since the right to vote shares of stock is, in itself, an asset, the trustees' fiduciary responsibility extends to the vote as well. This means that the trustee is obligated to vote plan assets according to the best interests of plan participants, which has resulted in making ERISA funds a major factor in corporate governance decisions affecting companies throughout the country.

Recent takeover activity has highlighted the pivotal role that pension plans can and are being required to play in a contest for votes.

Second, ERISA requires that assets be managed prudently. While prudence has never been easy to define, it is clear that the more experts who can be found to ratify the wisdom of a certain investment decision, the more it will be deemed to have been prudent.

ERISA has, therefore, actually encouraged delegation of fiduciary responsibility by the plan sponsors to outside experts. Often the delegatee is a bank, insurance company or a securities dealer.

Given the competition for lucrative ERISA business, these fiduciaries must demonstrate superior results in order to retain clients. Often this entails bringing in their own experts to measure performance in a way that shows optimal results. The result has been the creation of a new, very large and profitable ERISA industry with levels of costs to the beneficiaries of the plans that have not really been carefully examined.

Finally, the size and coverage of ERISA plans has forced consideration of an issue that the act's sponsors did not address, namely, what is U.S. pension policy, or do we even have one?

I simply mention this, Mr. Chairman, for purposes of completeness. I appreciate that the consideration of pension policy issues is beyond the authority and the interest of this subcommittee.

There is no explicit understanding of how private pension plans relate to the other two components of retirement income: savings and Social Security. Even within ERISA, there is no basis for judging whether the present ratio of defined contribution to defined benefit plans is proper.

On a larger scale, we really do not know whether the benefits of ERISA warrant its cost. In an age of unprecedented budget deficits, it must be recognized that ERISA contributions are the largest single corporate tax deductions taken, yet we don't really know whether real retirement income is being produced for workers. ERISA's annual costs to the Government are somewhat in excess of $43.2 billion a year.

Mr. Chairman, I apologize for using such a large figure without being able to specifically pin it down. I do refer to the special analysis of the budget of the U.S. Government which contains these rough numbers, but I am frank to tell you they aren't broken down as between public and private plans. So I use the figure of $43.2 billion as my best guess, knowing that it's an awful lot of money.

Whether the results justify the cost is not known, since there are no policy objectives against which to measure performance. In short, we don't know whether the objective of secure retirement income is being met at all, and if so, how well.

Before I get to the fourth consequence, let me underscore that because the first three were unintended, the size of ERISA funds, the size of the special ERISA industry, and the absence of a national pension policy, no one is responsible for them. There is no executive branch office nor legislative committee with oversight duties relating to these areas, specifically.

The one common denominator to all is the management of pension assets, which should logically be the concern of the Department of Labor.

If this is the case, the pension office, OPWBP, should hardly be seen as a mere issuer of exemptions, but rather as a specialized financial agency with the need for capabilities similar to the SEC or the IRS. This would have major implications for the way the office is organized and the kind of people who would be included in its staff. But since no one foresaw that ERISA would have such consequences, no one thought to provide for them.

These are not insignificant developments. As a part of its deliberations, the subcommittee might consider who should be responsible for their oversight.

Finally, the administration of ERISA was divided among two executive branch departments and three agencies within those departments.

I will speak only about the agency which I ran in the Labor Department, OPWBP. This office, which is charged with the administration of title I of ERISA, has five programmatic functions: reports processing; enforcement; exemptions; research and policy;

and administrative activities, including answering public inquiries for assistance.

I will focus on the first of these—reports processing—to illustrate the total disfunctionality that is the result of efforts to administer this law. It is so complete as to render the word "unintended" a joke.

Each ERISA plan must file an annual report with the Federal Government. The report form, known as the Series 5500 form, Mr. Chairman, of which this is a copy, is roughly six pages plus appendixes which can be quite long. It requires a wide range of information on any given pension plan which, depending on the size of the business, can include detailed entries on plan participants, no fewer than 100 lines on plan assets and liabilities, a certified accountant's opinion, and names and identifying information on any contractor who serviced the plan.

Currently the 900,000 forms submitted each year are completed by hand. Once they reach the Government, a lengthy and expensive process starts in which all the 5500 data are manually key entered on computer tape.

Without dwelling on the rather painful aspects of this system, let me summarize it by saying that by the time ERISA data actually reach the Labor Department, they're full of errors, they're incomplete, and they're up to several years old.

I know it is not uncommon to hear that Government information systems are inadequate, outdated, and painfully slow. But consider what it means to have no current and only incomplete historical data on ERISA plans. It means, Mr. Chairman, no one knows anything about the biggest single lump of capital in the world. It means there is no way even to start to assess whether the program is cost-effective because no one can measure the benefits.

In programmatic terms, consider what it means in an office where every single function turns on information. It means that enforcement staff must base their investigations on newspaper articles and phone calls because by the time they have access to the annual report data, the statute of limitations has usually run. It means that the research staff who are charged by the law with conducting studies that will serve as the basis for future pension policy recommendations are making so-called forecasts from material that is several years old.

Considering the imposition that is placed in the private sector to assemble this information, if this is the best use to be made of it, it ought not to be required at all.

It is unthinkable to contemplate the IRS or the SEC basing their enforcement efforts on financial data anywhere near as inadequate as that available to ERISA enforcement personnel. Effective enforcement depends on the systemmatic review and audit of annual filings. Indeed, to a great extent, compliance with any law turns on some degree of public belief that if a Federal return is required, someone in the Government will open that return, read it, and act on it if warranted.

No such belief whatsoever exists in the ERISA community as we have heard directly from many of those who fall under its enforcement provisions.

To what end, therefore, this charade. Each year the executive branch spends between $10 and $20 million and 100 full-time staff years to process ERISA data. Each year it is conservatively estimated that the private sector spends $120 million just filling out 5500 forms. Yet the end result of the entire process is useless information and dysfunctionality in the programs that depend upon it.

In your letter of invitation, Mr. Chairman, you asked several specific questions which I will address now. With regard to the priority given ERISA by the Department of Labor, let me applaud Secretary Brock's decision to elevate the Administrator's status to that of Assistant Secretary. That is in and of itself a big step forward.

It is also vital that the pension office be given the additional support necessary to function as a professional organization. This means giving the pension office its own budget as a line item, making it possible for appropriate legal help to be hired, and promoting the professionalism of the office in a way that will attract high quality candidates to its staff.

None of these can be accomplished without the complete support of the top level Labor Department officials who understand the resource needs of the pension program.

There is no question that during my tenure at the Department, there were not sufficient resources to administer the law effectively. My written submission contains detailed reviews of current resource levels and recommendations for enhancement and reallocation.

With regard to enforcement, I will repeat that as currently carried out, ERISA enforcement efforts are extremely meager. I want to repeat here, Mr. Chairman, that the Assistant Administrator responsible is an extremely competent person whom we feel very lucky to have hired. At the risk of redundancy, I want to stress that the professional quality of the principal officials in the Department is high and competent to carry out the programs. The problem is resources and direction from above.

During my tenure at the Department I convened the Enforcement Task Force which included senior legal and pension office staff. The task force was charged with a thorough review of the enforcement function. Its report, which I have included in my submission, supports the conclusions of several congressional inquiries that at no time since the passage of ERISA have adequate resources been devoted to enforcement. The report contains specific recommendations for improving enforcement efforts.

I have mentioned the critical need for better information on ERISA plans. Clearly, given the constant growth in pension plans, there is no way the Department can ever get on top of the statistical problem by dealing with paper-based reports. The use of computer technology is the only cost-effective approach.

While I was at the Department we designed and ran a pilot project; it was a successful test of submission of annual report data on computer tape. The pilot was a great success. And it showed that significant time and money can be saved by both the private and public sectors if a transition is made from paper forms to computer tape.

We know that the majority of all filers retain their report information on computers. We know the Government can process computer tape, and we know that using computers can give the Labor Department, the Internal Revenue Service, and the Pension Benefit Guaranty Corporation, the three agencies who use ERISA data, timely, accurate, and complete information, none of which is now available to anyone.

I regret to say that while the pilot was successful, the pension office as of my latest information did not have the Department's approval to spend any more money on developing a full-fledged electronic filing system.

As of this month, Mr. Chairman, indeed as of this Friday, the last day in June, the funds will run out and a Government-initiated solution to an enormous paperwork problem will die for lack of followthrough.

With regard to the prohibited transaction process, great efforts barely keep pace with the mailbags. The pension office receives between 600 and 900 applications each year requesting approval for some ERISA investment that falls outside of the traditional categories, specifically authorized by law. This was anticipated and accommodated by the statute in setting forth an exemptions procedure.

What was not foreseen was that the flood of exemption applications, time pressures, and meager support would put the Labor Department staff at a distinct disadvantage in trying to keep up with the creativity of Wall Street.

Mr. Chairman, during my tenure, in order to get the backlog down to what was considered an acceptable level of 350, one person, a senior official, took home these applications for months at a time, and this one person accounted for keeping the level at respectable proportions.

There is no limit to the sophistication and novelty of financial schemes that ERISA money managers develop. But it's unrealistic to think that anyone outside the core of the financial community has ongoing access to the detailed financial skills that are necessary to evaluate the exemption requests that come into the pension office.

One sensible solution, which can be implemented within existing resource constraints, is to create a self-regulatory organization [SRO] that could augment the Department's staff with a privately staffed and funded source of expertise. There is precedent for the use of such an SRO including the National Association of Securities Dealers and the Financial Accounting Standards Board.

In December of last year, we published a Federal Register notice soliciting comment on the concept of an SRO. Responses were generally positive and many of those who commented expressed their willingness to work with the Department on a joint task force to pursue the study and possible creation of an SRO for the ERISA exemption process. A summary of these comments is included in my written submission.

Your letter also addressed the question of fiduciary responsibility under ERISA. Again, I will take the liberty to submit for the record an article written for Barron's that sets forth the primary problem that has arisen in this area. Let me briefly summarize it by describing a hypothetical takeover situation.

Bear in mind, Mr. Chairman, that ERISA plans must be invested and managed for the exclusive benefit of the plan participants and beneficiaries. This requirement encompasses the exercise of voting power every bit as much as the investment power. But consider the dilemma this poses for major ERISA money managers: the banks, insurance companies, and securities conglomerates.

Let's take hypothetical company A, whose ERISA funds are managed by bank B. The bank also manages pension portfolios for 10 other large companies and has purchased company A's stock for all 10. Enter company A's pension officer one day with an additional $10 million in pension funds for the bank to manage and, coincidentally, a small request. Company A's annual meeting is coming up and a certain antitakeover measure is on the proxy. Company A would certainly appreciate it if bank B could make sure all the proxies it hold~~s are vot~~ed the right way.

Needless to say, the bank justifiably worries about keeping company A as a valued client, but it also holds trustee responsibility for the other 10 pension portfolios whose best interest may well lie in company A being available for acquisition.

Are such exchanges taking place? In the Wall Street Journal, Mr. Chairman, of May 10, an unknown money manager was quoted as saying that he had, in fact, received calls from Unocal officers on exactly this issue. When one considers the few large entities that control the bulk of pension fund assets—in 1984, the 100 largest plan sponsors owned more than half the assets—it is clear there are extensive overlapping networks of connected companies who have commercial relationships with virtually every significant financial service provider. The number of phone calls that could be arranged to a fiduciary with an unacceptable view of exercising his responsibilities boggles the mind. It's a very large number.

I believe it is vital that the Department of Labor work with the private sector to promote better understanding and fulfillment of fiduciary obligations. To some extent these obligations are neglected out of ignorance. To some extent they're neglected out of the almost certain knowledge that the pension office is not equipped to effectively enforce the law, so that wrongdoers need not fear being caught.

But, again, awareness and self-regulation by the private sector are the only solutions. There is no need for further regulation; there is no need for more laws. ERISA is sufficiently comprehensive to offer whatever guidelines are needed.

As I have said, there are detailed recommendations in my written submissions on all of these issues. I hope they will be helpful to the subcommittee in these hearings and to Secretary Brock and his appointees in their agenda for the Department.

For the record, let me just simply list these documents which I've submitted.

They include the Administrator's annual report to the Secretary which contains the Enforcement Task Force report, the report of the National Pension Forum, electronic filing material, and long-range plans for all the components of the pension office, the summary of hearings held in January 1985 on corporate governments, a summary of SRO comments received pursuant to the Federal Register notice, and the Barron's article.[1]

Senator **Cohen**. All those documents will be included in the record, Mr. Monks. I might say by way of caution in light of the volume of material that you've submitted, it might very well meet the same fate as the Form 5500 that has been filed under ERISA.

Mr. **Monks**. I take the admonition—let me close by saying there are two separate levels of ERISA consequences that bear examining. The first is the fundamental change that has occurred in the nature of capital markets as a result of the massive size and presence of pension fund assets. We can watch market movements, corporate takeovers, and huge daily trading volumes on the exchanges and see what the financial repercussions of $1,000 billion are. What we cannot do is measure the relationship to guaranteed retirement income for American workers, the objective for which ERISA was passed.

On the second level, we can comprehend that the Government's administrative responsibility for this enormous program has become even more critical than the original sponsors could have envisioned, simply because of the unintended consequences. Yet, the resources committed to the administrative task as it is now understood are not its match.

If ERISA's goals are still worthy, we owe it to those covered by its provisions to administer the act seriously. I hope the subcommittee will include both levels of discussion in its deliberation.

Mr. Chairman, before ultimately concluding, I would like to point out to you that in the course of these not brief comments, I've never mentioned the word "welfare" plan. Yet, the title of the statute is, "benefit plans." The office is called the "Office of Pension and Welfare Benefit Plans."

There are some 4 million benefit plans and it might give you some kind of perspective of the level of understaffing to think that someone who worked quite hard at being Administrator is capable of summarizing his career there without ever once mentioning the word "welfare." We know from the past that abuses have broken out in the area of welfare plans and the amount of money involved. The annual contributions paid to welfare plans are as large as the amount of money paid annually to pension plans.

That concludes my remarks. I'd be happy to take questions after my copanelists have spoken.

Thank you, Mr. Chairman and members of the subcommittee.

Senator **Cohen**. Thank you very much, Mr. Monks.

I do intend to turn to Mr. Clayton and Mr. Lanoff for their statements, but it seems to me that you've made a very powerful statement. There is a tremendous amount of money involved in ERISA. There is a tremendous amount of power involved in this program and there is a tremendous amount of potential for abuse, and no one seems to be terribly concerned about it.

With that, Mr. Clayton, you might wish to begin.

Mr. **Clayton**. Thank you, Mr. Chairman.

I appreciate the opportunity to be here today.

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[1] See additional materials submitted for the record, p. 211, et seq.

I, for the most part, in fact in almost every respect, I agree with the things that Mr. Monks has said, and I'll briefly highlight the remarks which I have submitted in more complete form on a written basis.

I can stress—as you have noted, Mr. Chairman, and as Mr. Monks has noted—how important pension plans and employee benefit plans are to the economy of the United States. When I was Administrator, which was less than 2 years ago, we were predicting that plans might reach $1 trillion by, I think it was, 1993. That was based on outdated information which Mr. Monks has very carefully set forth why that problem exists. There's already 1 trillion dollars worth of assets in pension funds. It's the largest source of private capital.

To me it really is amazing that so little attention is given to such a huge capital base and so little money is spent in trying to understand it.

I think at the same time, in looking at the regulatory policy on ERISA, regulatory policy has to balance two competing interests: One, assuring the free flow of capital to the marketplace—and I think it's important that the market ought to be allowed to direct where capital is going to go and two, the security that American workers desire and deserve.

It is quite ironic that an industry so large as the pension industry gets so little attention from the Government and receives such a minuscule allocation of resources in comparison to the regulatory task.

In my testimony, I spent some time reviewing some of the past problems of ERISA. I wanted to note that my criticisms are directed more at structure and procedures rather than at the personnel themselves.

When I first began working for the Government, I had the too often held view by many outside the Government that most Government workers were lazy 9-to-5 bureaucrats who sat around thinking of ways to make things difficult for the rest of the public.

My views changed, and I discovered the quality and dedication of the professional staff, particularly of the OPWBP, and I heartily reflect the comments of Mr. Monks. Many of these people are some of the finest professionals that I have ever worked with. They are very capable, and they have done a remarkable job given the resources which they have had.

Many of them have worked for the Government at substantial sacrifice. Their skills are marketable. Most of them are there because they believe in the program, and they are really committed to doing the best job they can.

From the beginning in OPWBP, there has been a debate between criminal enforcement advocates and those advocating a civil regulatory enforcement program similar to the SEC or the Internal Revenue Service. Most of the criminal advocates were those oldline Department of Labor people, mainly from the old Labor Management Services Administration.

Over the years there has been bureaucratic in-fighting in the Department of Labor between the criminal advocates and the civil advocates, particularly between those who were transferred from the

Internal Revenue Service under the 1978 reorganization order. Over the years enforcement policy has swayed to and fro.

I am not imputing bad motives to the criminal enforcement advocates, who honestly believe that is the best way to enforce pension laws, nor do I deny that there are criminal elements in some employee benefit plans. However, OPWBP is not well equipped to conduct criminal investigations, whereas, the FBI and the Department of Justice are.

Senator COHEN. I might point out, Mr. Clayton, that Congress must bear a large measure of responsibility in inflicting upon the Office of the criminal duties. By the passage of the Comprehensive Crime Control Act last year, we mandated that the Office undertake criminal investigations.

Mr. CLAYTON. I am well aware of that, Mr. Chairman. I think conducting civil and criminal investigations creates a lot of problems, although there are certainly criminal elements that have to be dealt with. In my view, most of the members of the employee benefits community with which I am familiar believe that the thrust of the Department of Labor in enforcement should be primarily civil, that the task of the OPWBP in regulating a giant financial industry involving billions and billions of dollars is more effectively done on a civil basis.

Hopefully, this would not mean that the Department of Labor and the Department of Justice would turn their back on important criminal prosecutions, and in cooperation with the FBI and the Department of Justice and the U.S. attorneys throughout the United States, the criminal problem in employee benefit plans can be handled.

Senator COHEN. I might point out that as we have increased the burdens of the Office we have also seen a decrease in the amount of staff and a reduction in the budget.

Mr. CLAYTON. The new independent structure of OPWBP is clearly a tremendous improvement over the past. I was delighted—as you probably know, I come from Utah. I don't know everything that is going on in Washington. My perspective is a little bit different than most Washington people—I was delighted to find out this morning that the Secretary made his determination to elevate the position of the Administrator to Assistant Secretary.

One of the recommendations I have in my testimony is that this was something that was long since due. I certainly congratulate the Secretary on that move. The elevation to Assistant Secretary will help in the coordination with other agencies. It will help in facilitating the enforcement of the law and, in essence, giving the program some of the clout that it needs to survive in the bureaucracy of the Department of Labor.

Another item which I would like to mention specifically, which Mr. Monks mentioned on a very broad basis, was with respect to the relationship of the Solicitor's Office and OPWBP and the need for OPWBP to have schedule A hiring authority.

ERISA is an immensely complex statute which requires the skills of trained lawyers to interpret. In order for the program to function effectively, it needs to be able to hire lawyers. To be able to compete for legal skills and be given the flexibility to deal with lawyers, it needs schedule A hiring authority.

Schedule A hiring authority has always been jealously guarded by the Solicitor. Understandably, the Solicitor has been reluctant to allow such authority to exist outside of his office.

Clearly, we do not want a duplication of effort in the program and in the Solicitor's Office. With appropriate coordination, schedule A hiring authority could immensely aid the program in accomplishing its tasks while not infringing on the prerogatives or duplicating the interests of the Solicitor.

Another item which I failed to mention in my testimony is the creation of line-item budgeting for OPWBP, which I understand is still for budgetary purposes listed under LMSA. If the program wants to have recognition and survive in the bureaucracy in the funding process, it has to have its own set of budget resources.

One of the interesting questions you asked me in your letter was to comment on the adequacy of resources. Given the immensity of the universe, the resources of OPWBP are grossly inadequate.

To give you an example of the immensity of the task, the OPWBP, if it were to randomly audit every employee benefit plan in the United States, could audit each program approximately once every 2,000 years.

Given the current budget climate, it is not likely that a major influx of resources to help OPWBP will be forthcoming. Because of the dim prospects of major funding increases, we should focus attention first and foremost on helping the program do better with what it has.

I think this improvement can happen in two areas, with some additional funding but not dramatic increases in budget. These are training and computer targeting and related computer support.

Nowhere is the inadequacy of funding for OPWBP more apparent than in computer targeting. The IRS recently completed a TCMP for employee benefit plan returns which took several years to complete and cost millions of dollars.

DOL was given an authorization during the period of time that I was at the Department of Labor for $500,000 to do some very beginning analysis. Because of the politics in the Department of Labor, that allocation never made it to the computer targeting process.

During my tenure with OPWBP, almost all cases which were being investigated were selected by hand from a review of 5500's. Some areas in the selection process were done through selection of 5500's by geographic area. Or there was some other item that appeared in the 5500, but the narrowing process was done by crude means and most of the work was done by hand.

Given the large universe, any meaningful impact the enforcement program wishes to have on the employee benefit industry will have to involve the use of computer targeting.

Over the years, OPWBP has attempted to obtain funds for computer targeting but has had difficulty. Resistance to the hiring of outside contractors, who could actually do the job substantially cheaper than in-house computer resources, was constantly thwarted for internal political purposes.

Resistance to upgrading the computer targeting capabilities of the program within the Department have to be overcome. Funds have to be appropriated to allow OPWBP to do a scientifically and statistically sound analysis of the 5500 as it relates to enforcement procedures in order to create some kind of meaningful computer targeting system.

An upgrading and training of field staff would also aid in enforcement and administration. There has been little money over the years to provide really professional training for those persons who have to audit employee benefit plans. Because of the relatively low entry level of field investigator staff, at GS-7, training is critical in order to upgrade their very basic skills to provide a meaningful enforcement program.

Currently, there is little meaningful enforcement of ERISA. After spending 1½ years in the private sector representing clients and dealing with other professionals in the employee benefits field, my impression is that most people either don't know or don't care about the Department of Labor enforcement of ERISA.

My perspective on this is essentially different than most of the Washington types in that I deal with plans every day, not on a lobbying basis but on a legal basis.

Senator COHEN. I want to interject. Most people don't know or do not care, and neither does the Department of Labor.

Mr. CLAYTON. I think there is a lot of truth to that, too.

Ironically, we have created a situation through the enactment of ERISA and the establishment of OPWBP which may create major problems in the future; that is, that plan fiduciaries can say to the world—"don't worry about us, we are regulated by strict statutes. So leave us alone—" while in reality they are poorly regulated and for the most part are free to do what they wish.

A private practitioner is immensely frustrated when he advises his clients what the law requires and what procedures must be followed, usually at some cost, when most of his clients' competitors ignore the law with impunity.

A meaningful computer targeting program and upgrading of the field staff through really professional training would certainly be a step to make that enforcement presence more meaningful.

Unfortunately, before you can have a meaningful computer targeting program you have to have some assistance to obtain the 5500 on a reasonable basis so that the information the Department of Labor has is reasonably current. As Mr. Monks has stated today before me, usually by the time the Department of Labor receives 5500 information it is about 2 years old. It is sometimes older than that, and it's full of errors.

I received a lot of complaints with respect to the 5500 as Administrator. I realize that it is one of the largest single paperwork burdens which originates in the Department of Labor. If this is the case, which I am sure it is, certainly the public ought to be concerned with the time it takes to fill 5500's out.

A scientific analysis of 5500 is critically needed to determine what the correlation is between the information reported on the 5500 and the apprehension of violators of ERISA. No study has ever been completed. Before any meaningful review of the 5500 can be done, such a study should be made.

Much valued information for statistical purposes that does arise from the 5500 and has been used in numerous studies by the Department of Labor and private pension groups. A study of 5500 that is undertaken from an enforcement perspective should also be reviewed by the academic community and others who utilize pension data to make important projections dealing with this vital segment of our economy.

With respect to the prohibited transaction process, in my early tenure as Administrator I made a decision which I have come to regret; that the best way to handle the prohibited transaction exemption problem under 406 and 408 was to adopt broad class exemptions which would facilitate beneficial transactions which would otherwise violate 406. We made some progress, but the gains were small.

Currently, it takes a minimum of 3 to 6 months—and 3 months is a very optimistic projection—to obtain an exemption. Such a timeframe is not realistic within the confines of ordinary commercial transactions. It is impossible in many instances for businesses to conduct transactions with plans having such delays.

In some cases the costs involving exemptions are also prohibitive, and in all instances they are too high. Absent a massive influx of resources to the Office of Fiduciary Standards, the division of OPWBP which processes prohibited transaction exemptions, the exemption process will not work because there are too many plans needing relief and too few people to process the exemptions.

The concept of an SRO is a good one, and I think it is certainly one which ought to be encouraged and in which more investigation should be made. However, I personally believe the only meaningful relief that could be obtained would be a change in the statute itself. That would be to go to what is known as an arm's-length adequate consideration standard in a prohibited transaction situation, coupled with a shift in the burden of proof to the party that engages in a prohibited transaction.

This type of standard would mean that if a transaction which otherwise violated 406 were in fact contemplated, and full consideration was given to the plan for the transaction, it would not be a violation. However, to make the standard more enforceable, the party claiming the benefit of the exemption would have the burden of proof to show the Department, if the transaction were challenged, that the transaction was arm's length and that it was prudent. If the party of interest did not meet the burden, then he would be subject to a penalty.

The Department of Labor has always contended that an arm's-length standard is unenforceable from an enforcement perspective, because it would require a great burden in litigation to show that the transaction was not for adequate consideration. Hopefully, a change in the burden of proof, perhaps with some other changes, might give the Department of Labor sufficient protection that a prohibited transaction provision will still be enforceable and provide the needed protection while allowing beneficial transactions to occur.

My criticisms are not a criticism of the Office of Fiduciary Standards. They have done admirably well. Given the resources, they have done a remarkable job of processing those exemptions which have been submitted to them. However, the universe needing prohibited transaction relief is so large and the staff of the Department of Labor is so small it can't hope to meet the demand.

I believe the only reason that the process has not bogged down completely is, one, that the Office of Fiduciary Standards has done a great job with minimum resources and, two, the prohibited transaction rules are ignored in many instances by the employee benefits community.

I think that is an important aspect. Basically—as a practitioner seeing the plans on a day-to-day basis, particularly medium- and small-sized plans, basically not only are the prohibited transaction parts of the statute ignored but the statute itself is ignored. The enforcement presence of the Department of Labor is so small that the risk is fairly small, and most plans are willing to take that risk.

The positions taken by the Department with respect to the duties of a fiduciary under ERISA in voting rights of stock in pension fund accounts—the positions taken by the Department of Labor today are certainly correct, and are mandated by the statute in relationship to the duty of fiduciaries with respect to exercising voting rights of stock held in pension fund accounts. A fiduciary cannot escape his fiduciary obligations under ERISA. A fiduciary has the duty to inform himself of the affairs of the corporation in connection with those matters which might affect the value or the rights which a plan has as a shareholder.

The fiduciary then must make a prudent evaluation of the issues and vote the stock accordingly. For too long there has been too cozy a relationship between some institutional fiduciaries and the companies whose stock the institutional fiduciaries were voting. In the past it appears that institutional fiduciaries routinely voted with management regardless of the nature of the policy.

In today's world of green mail, poison pills, golden parachutes, and all kinds of creative devices to protect entrenched management, plan fiduciaries have an even greater obligation, particularly when they own large blocks of corporate stock, to keep themselves informed as to corporate governance issues and other issues which affect the value of plan investments and vote accordingly.

It is very difficult for the Department of Labor to enforce these fiduciary obligations unless the abuse is brought to their attention. The Department has no way of knowing how a particular fiduciary is going to vote on the issue unless given notice through publicity or complaint of the participants.

Further, timeframes are often very short, and it is difficult for the Department to do sufficient indepth investigation to be able to respond within the time constraints it often must meet.

The situation is further complicated for the Department because the parties in a typical corporate fight are well financed. For the Department to take them on means a major commitment of scarce resources. I would think the Department would not want to get involved unless the abuses were quite clear and clearly to the detriment of the participants and beneficiaries.

The Department of Labor in a corporate takeover situation has articulated its position very well. In short, when fiduciaries are involved in a corporate takeover situation, the decision to tender or acquire shares must be made solely in the interest of plan participants and beneficiaries. Where management trustees are in control of the plan which is involved in the corporate takeover fight, an irreconcilable conflict of interest exists. Management trustees should either resign, allow independent trustees to make the decisions, or should obtain independent objective advice and act upon that advice.

Corporate fiduciaries cannot blindly hide behind plan provisions which direct that the stock may or may not be tendered or may only be tendered under certain circumstances. Such a provision is designed to make tendering more difficult.

Although a plan fiduciary must follow plan language, this obligation exists only so long as the language is consistent with ERISA. Provisions which are designed to prevent the tendering of stock and place restrictions upon such tender, under many fact circumstances are violative of the law. Nor in most instances can plan fiduciaries pass on the decision to plan participants as to whether or not to tender the stock. I am unaware of any provision in ERISA which allows such a decision to be passed on to plan participants except in the case of an individually directed account.

Certainly, the fiduciary may take into consideration how plan participants of beneficiaries vote on an issue, but such fiduciary still has an independent duty to exercise his responsibility with respect to the tender offer. In circumstances where the information which has been passed on to the shareholder or the participant is incomplete, where the mechanism for voting does not give plan participants adequate opportunity to express themselves or the nature of the information or the circumstances surrounding it would lead to coercion or misinformation, any vote of plan participants should have little weight in a fiduciary decision to tender or not tender.

Retirement funds were not intended to be tools of entrenched management to protect themselves or allow management to further corporate interests. Although ERISA recognizes that fiduciaries may have two hats, that of a corporate manager and trustee, when acting in a fiduciary capacity such a manager must act in full compliance with fiduciary duties under the law.

Corporate takeover situations highlight some of the limited enforcement capabilities of the Department. As with the corporate governance issue, the parties may be well financed, and to take them on requires a major commitment of resources from the Department. Almost always, time constraints are very short, which leaves the Department little time to analyze the issues and take appropriate steps before the harm is done.

Even with these problems, where the Department has chosen, to intervene, they have been effective and they are certainly to be commended for their efforts.

Secretary Donovan suggested at one time the Department was going to create response teams which would have particular expertise in the corporate takeover area. These teams could be called upon to investigate and develop information to enable the Department to act quickly and decisively in these situations. Such a concept is one which merits consideration. Perhaps some sophisticated training from the field to the national offices and the Solicitor's Office in corporate governance and takeover issues might well enable the Department better to respond in a more effective and timely fashion.

The Department has done an excellent job in establishing fiduciary concepts arising from the corporate governance and takeover situations. Given the resource restraints, I doubt they could have been expected to do much more at any time.

The bottom line is, as I mentioned and as Mr. Monks mentioned, the task is enormous, the resources are minuscule, the priority that has been given the Department of Labor's prevention programs has been very low.

As a result, in many cases—and certainly there have been some well-done enforcement cases—but in most cases it is my belief, particularly as a pension practitioner, that the law is essentially ignored.

Senator Cohen. Mr. Lanoff.

Mr. Lanoff. Mr. Chairman, my name is Ian Lanoff.

I appreciate very much the opportunity to appear this morning before your subcommittee. It's tough being a has-been at my tender age. I'm also for your placing me third in speaking on this panel. It permits me to say that I'll try not to be repetitive and by that what I really mean is that I'm not as articulate or as thoughtful as these two who preceded me.

I was Administrator from May 1977 until December 1981. That's longer than the other four Administrators' tenure combined. I hope my foolhardiness in holding onto the job with all its frustrations for that long won't affect my credibility this morning in testifying before you.

What I'm going to do is respond to the questions that you posed to me in your letter rather than going through my written testimony which I've already submitted for the record. And I must say I commend your staff for these questions; they're good questions, and they made me think about some of these issues for the first time in a long time.

First of all, you asked about my views on the current structure of OPWBP and the priority given to the management and enforcement of ERISA by the Department of Labor. Let me say that I'm prejudiced in favor of a single agency. Frankly, I think that's the only way that this program will ever be effectively run. In my view, anything that's done which is short of establishing a single agency is merely tinkering. The structure of OPWBP—even when I was there, it wasn't even OPWBP, it was PWBP—has been tried every which way.

I don't think it really matters that much what the structure is although I would say that the more independent the program is within the Department of Labor, the more chance there is for improved performance of the program within the Department of Labor.

While I was there I probably had less authority on paper than any of the other Administrators, perhaps with the exception of Jeff Clayton, who succeeded me. And in some areas I was successful, notwithstanding the fact that the program was buried deep within the bowels of the Department.

I don't agree with some of the statements I've heard this morning, that ERISA is not a high priority of the Department of Labor. I think ERISA is not a high priority at the Department of Treasury or the Internal Revenue Service, but I don't think anybody can really say, honestly, that the Department of Labor has not made ERISA a high priority.

The problem has been that in a Department like the Department of Labor, there are so many other competing priorities. I think it's wrong to expect any Secretary to put ERISA ahead of some of the other programs that a Secretary of Labor needs to concern him or herself with.

How could you put ERISA ahead of OSHA or mine safety or job training? I think you can put it alongside those, and I think that's what the Department has done throughout the different administrations that have been in office since 1974.

Your second question involves the adequacy of resources available for the implementation and enforcement of ERISA.

Senator COHEN. Mr. Lanoff, if I could just interrupt you. I think I was the one who made the observation that the Labor Department didn't seem to care very much. It seemed to me based upon what I've heard today with respect to the 5500 forms, with respect to prohibited transaction exemption requests and so forth, that the Labor Department would have a compelling obligation to come before Congress and say we need more money; we can't afford to cut our staff down from 250 to 195; we can't afford to have a reduction from $30 million down to $28 million. This simply can't go on because this is as important as mine safety in terms of the amount of money involved and the potential for abuse in this country's corporate structure. We need more help. The pension program has not, in my judgment, received that kind of level of attention by the Department.

So it's my observation, based upon a lack of a compelling desire on the part of Labor to bring this to a focal point before the Congress, and to say this is terribly important and the system is not working. So I take that responsibility.

Mr. LANOFF. OK. I agree to some extent with your statement but not completely. I'd like to address some of the things you raise as I go along here.

You asked about the adequacy of resources and my recommendations.

As a former Administrator and as one who's hung around with administrators of the ERISA Program and others, I don't think any administrator ever feels that resources are adequate. I think to some extent it's something those who run Government programs and private sector programs hide behind. Nobody ever has adequate resources.

I think the key isn't so much to have more resources, although, of course, that would be welcome; I think the key is to set priorities with the resources that are available.

To give you an example, when I was in the Labor Department, we established an enforcement strategy. It was called the significant case approach.

Basically, what we decided to do was to emphasize investigations of larger plans, both corporate-sponsored plans and so-called Taft-Hartley plans which had been negotiated by unions. To the extent that we would investigate larger plans and uncover potential violations, there would be a better chance that we'd be protecting a greater number of participants, either preventing transactions that would harm the value of the plan assets or go after recovery in situations where plan assets have been illegally abused.

I think that the significant case approach worked quite well. I think it focused the attention of the limited personnel in terms of what they should be investigating, and we came up with over 120 cases by the time I left in 1981. These were cases which, in my view, if they had been followed up on, would have sent a message to corporate America and to unions that sponsored plans that the Labor Department was serious about enforcement.

Senator COHEN. As I recall, though, I think it was the inspector general and the LMSA that had a combined investigation, known as the Walsh report, that specifically rejected that approach.

Mr. LANOFF. Yes; and I'm sure if I had done what they had wanted, which was to pursue criminal investigations, look at smaller plans and catch people who hadn't filed their forms, then they would have come out with a report that said we'd ignored the larger plans and should adopt the significant case approach.

I am very critical of the Walsh report. I think it unfortunate that Mr. Walsh later came into the Labor Department. As a result, Mr. Clayton lost control over the enforcement program at ERISA. From what I understand, as a result of the dropping of the significant case approach, the program switched to an entirely new approach, and the enforcement effort went into a tailspin from which it has yet to recover.

I said when I was in the Labor Department—it's sort of trite but I think it's true—if you try to do everything at once, you end up doing nothing forever. You have to set priorities and you can't do everything. Within the available resources, there's no way that ERISA—even if it's a single agency, you have to be realistic about it—will ever have the resources to look at the large plans, look at the small plans, do criminal investigations, and make sure that everybody's filing their reports. Someone's going to have to set priorities to make sure the best job is being done with what's available.

Let me say in terms of resources, it's not only numbers that count. I agree with what Mr. Monks and Mr. Clayton said this morning in terms of schedule A authority. I agree that since the Solicitor's Office in the Labor Department has schedule A authority certainly all the programs should have schedule A authority, not just ERISA, but certainly ERISA should. Perhaps ERISA has a greater need because of the complexity of the law and the need to hire people who have sophistication and expertise in the areas that the Department needs to regulate.

Let me also add, however, that I strongly believe that the positions within the ERISA Program should be upgraded in order to attract and maintain good staff.

One of the things that's happened in the Department—they tried to do it when I was there and I was able to stop it, but apparently they've succeeded since I departed—and that is they downgraded the positions in the field. The regional offices have been eliminated and as a result of that, there are fewer SES grades and GS-15 grades than there formerly were. To me this is moving the program in the opposite direction from which I believe it should move. I think that's an extremely important point. This is one situation where I think ERISA does require special consideration again because of the extra sophistication and expertise needed by its staff.

I'm only being half facetious when I say that one way to add to the resources in terms of numbers of the Department would simply be to take the 1,000 investigators that are currently at the IRS—God knows what they're doing over there—and just bring them over to the Labor Department and have them work in the fiduciary investigative area. I think that would go a long way to solving the Labor Department's problems and maybe it would solve the IRS problems, too. Then they wouldn't have to be defensive about what they're doing with those 1,000 people.

Again, I think there are problems today. I would recommend a return to the significant case approach. To the extent that there's a need to concentrate on smaller plans, and criminal investigations, try to figure out some way to set priorities there, too, make random audits or whatever, or work with IRS. IRS seems to have more of an interest in smaller plans. Maybe there could be a smaller plan IRS program and a larger plan DOL program. Coordinated properly it might work quite well. Although, as I point out in my written testimony, the Labor Department has had very little success in attempting to coordinate enforcement efforts with the Internal Revenue Service.

Today the DOL and the IRS share enforcement authority. DOL does not have exclusive enforcement authority even though it is DOL, as a result of reorganization plan No. 4, that has exclusive authority over the fiduciary provisions of ERISA in terms of rulings and regulations.

One of the things that's occurred under Bob Monks' tenure, is the establishment of a national office investigative force patterned after the SEC. I very much commend Mr. Monks' for establishing that investigative force in the national office. It will improve enforcement significantly to the extent they'll be able to identify and react quickly to potential violations.

I wouldn't, however, support the idea if it means a downgrading of the field. I was very pleased with the performance of the field people when I was at the Department; I thought they tried very hard to learn as much as they could. We needed a little bit of help in terms of training them but they also went outside of their training programs and did training on their own.

I know one of the recent moves in the Department has been to eliminate many of the field offices. I fear they are losing good people as a result of that. I know the Department is losing some good people as a result of that, and I'm very much concerned about that.

You asked about the use of the 5500 as an enforcement tool. One of my constant frustrations when I was at the Labor Department—and it is apparently still a problem as I heard this morning—is making the 5500 forms an enforcement tool. Basically, the reason the 5500 forms are not now available as an enforcement tool is a good example of reform run amok.

Before I was an Administrator, at the tail end of the Ford administration, someone had a brilliant idea to reduce paperwork. The 5500 forms which had formerly been filed with all three of the ERISA agencies, would henceforth only be filed with the Internal

Revenue Service. I tried very hard to reduce paperwork as have all the other administrators. But why this one was adopted I never could figure out.

Why was it so important to save sponsors the cost of mailing one six-page form with some attachments to the Labor Department and PBGC as well as the IRS? I don't think that was a big deal in terms of saving paperwork. As a result of it, more harm was done to the DOL enforcement than almost anything that's been done in the history of ERISA.

The IRS has not been cooperative; they have given the Labor Department nothing but trouble in connection with making 5500's available. Just to give you an idea and to confirm what Mr. Monks and Mr. Clayton have said this morning about the dedication of DOL staff, field staff that worked for me would go to the IRS service centers and beg for copies of the 5500's so that they could peruse them and possibly identify potential enforcement cases. Some IRS service center people were cooperative and some weren't.

To the extent they were cooperative the field offices were able to identify potential violations; to the extent they weren't, they weren't. But it was almost as if we were foreign governments rather than agencies with the dual task of enforcing ERISA. And from what I've heard, I don't think that's changed.

Senator COHEN. I understand the field offices are now looking at 5500 forms that were filed in 1981 as the basis for their information.

Mr. LANOFF. That doesn't surprise me.

To me, an easy way to solve this problem would simply be to reinstate the requirement that these forms be filed with the Department of Labor as well as IRS. To have them filed with the Department of Labor instead of IRS is not realistic. Maybe you could call the IRS officials up here and beat on them a little bit.

Senator COHEN. A better course of action might be to talk to Vice President Bush and his antiregulatory paperwork reduction goals. Perhaps he might want to reverse some of the goals of the administration and put some of that paperwork back.

Mr. LANOFF. I would like to make clear, people accuse the Labor Department of not caring and just burying these forms. I think that's the furthest thing from the truth from what I can tell. They were very anxious to get their hands on them and to use them as an enforcement tool.

I fully subscribe to Bob Monks' idea to use modern equipment for filing. That may also go far to solve part of his problem if there's some way that the information could reach the Department in a more expeditious fashion.

Your next question involves prohibited transactions.

Ever since reorganization plan No. 4, which gave the authority to the Labor Department with respect to prohibited transaction exemptions, I think the Department of Labor has done a commendable job in terms of processing these applications for exemption.

I don't agree with Jeff Clayton and what he said this morning about changing over to an arm's length standard in place of the current prohibited transaction process. To me the strongest part of ERISA enforcement today results from the fact that plan officials and parties in interest to plans are required to examine the transactions before they engage in them because they may engage in a prohibited transaction unless they do. They're all afraid of the imposition of an excise tax by the IRS. If they engage in a transaction without this fear, I'm afraid that there would be many more violations and abusive conflicts.

Senator Cohen. According to Mr. Clayton, nobody is afraid of getting caught; everyone is engaged in prohibited transactions.

Mr. Lanoff. He must have different clients that I do out West. My clients are concerned about Government enforcement. Even if they haven't seen it themselves, they know it's just a matter of time before there is an effective enforcement program conducted by the Government agencies.

And I think the fact that you're holding a hearing today suggests that it won't be long before enforcement is pursued more seriously in the Agency.

Senator Cohen.What would you say the chances are of getting caught? Mr. Clayton is saying it would take 2,000 years to audit every program out there right now, every plan.

Mr. Lanoff. I don't think the question is how many plans can you audit just like the question isn't how many taxpayers can the IRS audit. I think the question is:

How many can you audit to have a credible program so the cheaters are afraid to cheat?

I don't think you need 2,000 to 3,000 auditors to investigate every plan in America. I think you may need 500 to 600 or maybe 1,000 to audit enough plans so that people are concerned that somewhere along the line, before the statute of limitations runs out, that they are going to be visited by either an IRS or a DOL, or let's hope a single agency, whatever they choose to call it, investigator.

I would agree with Jeff Clayton though, that I would like to see a little bit more emphasis by the DOL staff on creating class exemptions, developing class exemptions. I think, after 10 years, they've had enough experience now so they should be able to put together some class exemptions to address routine type situations that could be monitored either by independent fiduciaries or by Department of Labor personnel.

I think they have the tools to do it. They've been somewhat swamped by individual exemptions, and it's been difficult for them to develop the class exemption program. But I think they should try.

Senator Cohen. Did I misunderstand you, Mr. Clayton? I thought you said one of the decisions you regretted was your advocacy of the class exemption.

Mr. Clayton. That's what I said, it was a good idea. The problem is it takes years to get one class exemption forward. And it just didn't work out. It only takes them a couple of years to get one class exemption; unless they either change the way they do it or substantially increase their staff, they're not going to be able to get enough class exemptions out to make a meaningful change.

In essence, my solution is I'm just throwing my hands in the air and saying the system isn't working.

Mr. Lanoff. When I talk about developing class exemptions, I'm not necessarily talking about the ones that takes years to develop, the ones that involve sophisticated financial transactions, say, by banks or insurance companies or investment advisors. I'm talking about some of the regular run-of-the-mill everyday types of prohibited transactions that occur as the result of small plan sponsors taking back a loan from the plan.

The Department by now has granted so many of those that there's almost a common law of exemption rules. It seems to me it won't be that difficult for the Department personnel to lift out some of the standards they've developed. I think that would eliminate hundreds of applications that are received every year.

Let me take up the remaining amount of my time and talk a little bit about fiduciaries and their responsibilities in terms of voting as shareholders on takeover situations; particularly you ask what is required of fiduciaries under ERISA in exercising the voting rights on stock held in pension fund accounts? And how well is the Department of Labor enforcing and providing guidelines with respect to these obligations?

Let me say first that I agree with what Bob Monks and Jeff Clayton said this morning in terms of fiduciaries being required to vote their shares to preserve and further their economic interest. It's important to say that here we're not talking about social investing where people are voting their shares because they're interested in matters other than the furthering of the financial interests of the pension funds as shareholders.

We're talking basically and exclusively about increasing or enhancing or protecting the value of shares held by pension plans in corporate America.

Also, let me say that we're not talking about pension plan fiduciaries diving into corporate America and attempting to run companies; we're only talking about pension funds as shareholders being required to follow up on their investments. And, in my view, the governing principles which apply to their activities in this area are the very same ones that ERISA requires, be applicable to the original investment decision. These are the basic fiduciary requirements, the duties of care and the duties of loyalty to participants and beneficiaries.

I think a shorthand way of looking at it is we basically are talking about a cost-benefit analysis here. What is the return to the plan as the shareholder for the cost expended in voting shares, keeping up to date and aware of what's going on with respect to corporate activities, getting involved in proxy fights, engaging in litigation, and those sorts of things. You have to weigh the costs against the benefits to the plan.

I think most attention has been paid in this area in connection with unfriendly takeover situations. Shareholder pension plans and money managers who have managed their money have been unhappy generally with some management actions which have denied shareholders the right to vote. Or, which have denied shareholders the opportunity to tender those shares because some of the shark repellents and other methods adopted by corporate America have in fact interfered with the ability of the raiders to even mount an unfriendly takeover attempt on a particular company.

This is the general problem. The overall issue is the fiduciary interests on the part of the institutions as shareholders to the takeover area—I think Bob Monks is the one who really identified this issue. He's a very creative guy. And I think we all owe him credit for that.

He gave speeches in April and October 1984 which identified these issues and heightened the awareness of pension plan fiduciaries throughout the country. But I don't think there's really been much followup.

I don't know why that is. Perhaps it's because he left. But there haven't been rules; there haven't been regulations. So, really, what pension plan fiduciaries face today is the No. 1 ERISA person in the country giving these speeches saying you have these obligations but really, there's been very little guidance afterward telling exactly what their obligations are. It's been left to private practitioners like myself to do that.

I think we're adequate to the job but there's nothing like the Government telling you what your obligations are to make you sit up and pay attention.

You ask what is required of fiduciaries in takeover situations and how well is the Department of Labor enforcing and providing guidance?

Fiduciaries in the takeover area are faced with several situations. Two involve just basic investment decisions. One is whether to tender your shares when you happen to own shares in the company that's targeted for an unfriendly takeover.

Another is whether to actually invest with the raider in junk bonds and in effect become a speculator.

Both of these decisions rely on the prudence requirement in ERISA. I think the pension plan fiduciaries are free to tender or not to tender under prudence. And I think that under prudence fiduciaries are free to invest in junk bonds if they conclude it's an appropriate investment under the circumstances.

Another area which you asked about was the offensive and defensive use of pension funds in takeover situations. This, to me, is an area of real abuse and I just don't think there's any place for this. I fully subscribe with everything Jeff Clayton said about it. I don't need to repeat it. I don't think the Department of Labor has provided much in the way of guidance on the first two issues I mentioned. Perhaps that's resulted in some confusion, particularly on the first issue, because I know some representatives of corporate America have blamed the pension plans for always taking the short-term view in takeover situations, and always tendering. And they somehow construe this as being required by ERISA or their fiduciary responsibilities.

I totally disagree with that. If any institution in this country is capable of taking a long-term view and weighing the benefits of permitting management to adopt shark repellents or other methods of thwarting takeovers it is the pension fund fiduciaries.

Senator COHEN. Here, I guess, you're joining with Mr. Monks in rejecting the Peter Drucker view that was espoused in the Wall Street Journal that you have an obligation as a fiduciary to sell at the best price.

Mr. LANOFF. I think, sometimes, you'll want to do that. Maybe in most situations you'll want to do that. But I don't think there's anything such as prudence per se under ERISA. Fiduciaries can weigh the pros and cons of doing it.

To me, a perfect example is the Grumman situation. As a result of Grumman successfully thwarting the takeover by LTV, Grumman stock is much more valuable today than it was during the time that LTV was mounting its unfriendly takeover effort.

I don't know what fiduciaries did. Perhaps they tendered to LTV at that time. If they had voted or bet their money that the Grumman trustees and corporate officials would prevail and that the company would become stronger as a result of a takeover attempt, and its ultimate failure, they could defend themselves today by pointing to the success of the Grumman shares. I think that's something that won't be that uncommon.

I think though in terms of the Department of Labor's response, the Department of Labor has done a commendable job in addressing abusive use of plan assets. When I was still at the Labor Department, I was the one who signed off on the complaint in the *Grumman* case. At that time, and in both situations where plan assets had been abused before takeovers, as in the Grumman situation, or to further takeovers, as in the *Leigh* v. *Engle* case, where the Labor Department came in as amicus, the Labor Department has been quite adequate. It has probably done the best job overall in terms of ERISA enforcements that any of us I think have seen.

The Department has also not hesitated to get involved in situations before they even develop into abuses. In the Carter-Hawley-Hale situation, the Department wrote a very strong letter to the Bank of America as to its fiduciary responsibilities in connection with the takeover attempt.

I know, from personal experience in the Phillips situation, the Labor Department became involved and forced the Phillips management to make some changes with respect to the ESOP they were attempting to put together as part of their recapitalization plan.

The Department has also been very active reviewing leveraged buyouts to make sure parties are not undervaluing the assets of plans when plans become purchasers along with others in a leveraged buyout situation.

I think the Labor Department is to be commended in this area. And this is a good example of how you do focus your resources. You do set priorities, and you can make your mark. I think, today, more than ever, that anyone who is becoming involved in a takeover fight knows the Labor Department is going to be a player. The lawyers all know that, and now I think the clients do, too. That's an example of at least in one area where the Labor Department has succeeded in using its resources in an appropriate way.

The final question. Do fiduciaries face conflicts in voting and investment decisions? And does the Department of Labor adequately address this issue?

Again, writing a letter in the Carter-Hawley-Hale situation and the *Bierwirth* case, I think demonstrated an awareness of conflict on the part of the Department of Labor. The conflicts are clear.

In the *Bierwirth* case, the Department attempted to persuade the court and failed that there's a per se conflict, what we call a section 406(B) violation. The Department argued that it is a per se prohibited transaction in a situation where trustees of a plan who are also the corporate officers who are threatened by a takeover make the decision one way or another with respect to the use of plan assets to thwart or further the takeover. In that case, it was thwarted.

But, unfortunately, the district court in the second circuit in New York disagreed. It said that they will just review activities of the trustees in this situation under the prudence standard. They did find the trustees to have violated the law. And it looks like the trustees are going to have hefty damages to pay.

But I think it would have been very beneficial in this entire area if the court had gone along with the Labor Department's thinking and had approved the theory that the trustees of plans in such a situation cannot become involved.

These kinds of decisions have to be shifted to outside independent fiduciaries when a takeover occurs because of the inherent conflict that these trustees face, their also being corporate officers whose jobs are at stake.

I represent a group that's become very interested in this area, the Council of Institutional Investors. Right now, it's made up primarily of public pension plans and Taft-Hartley funds, although just the other day we got our first corporate member, U.S. West, one of the baby Bells.

What basically this group is interested in is making sure that corporate officials don't take action which threatens the well-being of pension funds as their shareholders. I must say though that this group is more interested in what's going on in the corporate boardrooms than it is in terms of what the Labor Department is doing.

The Labor Department, as I say, is a player but it's much more important for pension funds and shareholders that State law, in my view, be cleaned up so that corporate officials cannot hide behind State law business judgment rules in order to thwart the interests of all shareholders, including pension funds.

I think recent decisions by the Delaware State Court in the *Unocal* and *Household Finance* cases go a lot further to hurt the interests of pension funds and shareholders than any abuse of plan assets has or is likely to do. The use of plan assets is just one form of shark repellent.

Really, when you look at the overall situation in the corporate takeover situation, it's much more important that Congress adopt a Federal fiduciary law that applies to corporate officials just as ERISA applies to pension officials and Landrum-Griffin applies to union officials to protect the interests of pension funds as shareholders.

Thank you very much, Mr. Chairman.

Senator COHEN. Just a couple of observations, Mr. Lanoff, before I proceed to some questions. First, I might inquire, Mr. Gordon, are you here? I hope you have a little bit of time because I'd like to take some time to ask these gentlemen some questions.

Mr. Clayton has traveled all the way from Utah to be here. Mr. Lanoff has also demonstrated his dedication to the pension program by being here today, as have Mr. Monks and Janet Brown. A couple of observations on my part, to begin with.

We have three outstanding, very highly competent individuals, all of whom have served as Administrators of the OFWBP, Mr. Lanoff serving the longest period of time. I guess part of the frustration must be that we have had seven Administrators in 11 years dealing with this program.

Is that correct? Isn't that part of the problem?

Mr. LANOFF. There have been six. We're about to get a seventh.

Senator COHEN. Seven. I assume all of you have left for different reasons but that much of it had to do with frustration. I suspect in one case, perhaps even some demoralization at the fact that things could not be done.

I'm concerned from two aspects.

First, is ERISA working as originally contemplated? Mechanically, is it working? Does it have the resources? Does it have the ability to carry out the general objectives that Congress set forth? I am also concerned, second, about the potential for abuse. I think the hypothetical that Mr. Monks mentioned in his article that appeared in Barron's magazine and also as part of his testimony here today, is not hypothetical at all. I think that it is probably a real occurrence in the corporate world, and it probably happens on more than an isolated basis.

In fact, I think that particular situation is the classic case that could involve criminal prosecution and that ought to be investigated. Perhaps the whole issue of the potential for that kind of activity taking place on a day-to-day basis, as part of day-to-day decisions being made by fiduciaries, ought to be investigated by the Permanent Subcommittee on Investigations of this committee to find out if, in fact, my intuition is correct that this kind of activity is going on on a daily basis. With that kind of money and that kind of power locked into an increasingly smaller group of directors and money managers and investment firms, I suspect it goes a lot more than hypothetically.

The other point that I would like to make involves the pattern of factors which often leads to abusive conduct. The Permanent Subcommittee on Investigations has held a series of hearings since I have been in the Senate dealing with fraud and abuse and organized crime. Whether we were investigating drug smuggling into the country or talking about chop shops, where stolen cars are chopped up in a matter of minutes, a pattern emerged. What we found, for example, in chop shop operations and in Medicare and Medicaid abuses was this pattern: You have very high profits; you have a low risk of detection; you have a low risk of apprehension; you have a low risk of prosecution, and you have a low risk of conviction, and even a lower risk of incarceration.

There you have the pattern for abusive conduct in our society in any program, in any department, and in any criminal activity.

It appears to me, as a layman having done a little bit of research into this field, that we have here the same sort of pattern that has been established elsewhere.

The fact that there really is not a great fear that there is going to be a serious audit or detection and the amount of money that is involved, it seems to me, would set in motion the very pattern that we have seen in so many other types of investigations carried on by the Permanent Subcommittee on Investigations.

I would like first of all to ask, perhaps, a naive question. Mr. Monks has suggested in his written testimony, and I am going to explore this a little bit in a moment, that maybe the responsibility for voting these shares doesn't belong with money managers at all, but rather it belongs with the sponsor of a plan. I am not sure that is a unanimous judgment by any means, but he makes the point that because you have so many interlocking interests today, there is such a potential for conflict with the money managers who have many different portfolios that they manage, and that perhaps the only sound measure of responsibility under the law is to place the responsibility for voting shares back with the plans sponsors.

If that were the case, the next question I would have is why do we need money managers at all?

I'll ask you, Mr. Monks, Why do you need money managers at all? On the one hand, you indicated that there is no measurable standard for performance. There seems to be a herd instinct. Whatever everybody else is doing is good enough.

If you can measure up to the common standard, whether it is 4 or 8 percent or whatever it happens to be at any given time, that is satisfactory, as far as prudence is concerned. My understanding may be false on this, but my understanding is that there is a greater concentration of pension fund assets going into the more stable blue chip corporations. That is safe. That is prudent. No risk and if you're not taking any risks, no liability. The attitude is let us just invest in the big companies who have some stability.

The question if you are going to put the voting responsibility back with the plan sponsors, is why don't you put the management functions back there as well? What kind of expertise is required to have an in-house system, whereby you can analyze where the blue chip stocks are and who is doing well among the big companies? Why farm all this out to money managers at tremendous expense to the beneficiaries? The only people who seem to be making a lot of money are the money managers, the financial institutions, and the insurance companies, who are making a pretty good profit when, in fact, they are shooting for a golden mean of little risk and not tremendous yields.

Mr. MONKS. Mr. Chairman, in my opinion, you have asked the most profound question. Obviously, it is an unpopular question, because a great many people are making a great deal of money, prudently using money for a lot of people.

The fact of the matter is that the thrust of your suggestions, to my way of thinking, requires extended consideration. Let me just try and consider some of the aspects of it, but first, to elaborate on your earlier intuition about the pattern of abuse, it reminds me very much of the comment—let me back up for a second. In considering the application of your intuition to the risk area, I commend to you the statement of Willie Sutton: when being asked why he robbed banks, he said "That's where the money is."

The amount of money in chop shops, even in drug abuse, is modest compared to the amount of annual cash flow and welfare plans and the amount of capital. I think you simply have to be naive to assume that we aren't hearing anything about abuses, and therefore, there aren't any abuses.

One of the things I've been trying to communicate to the subcommittee within the little bits of language is that the lack of real knowledge is a very serious matter here.

My own inclination would be very much along the lines—I would be frightened myself as to actually what is happening today.

Turning to the question of the need for money managers, one of the aspects of the ERISA Program that is so difficult to get one's hands around, is simply the size of what you're talking about. I mean, Mr. Chairman, if you are talking about $1,000 billion, you're talking about a third of today's capital value of all the exchanges. You're talking about the market. How could a third of the market, approaching to half the market, perform better than the market? It is the market in another manifestation. It is the same question that Mr. Lanoff was addressing himself to, and Mr. Clayton.

How can you talk about concepts, duties of loyalty, duties of care that are characteristic of a very pristine law of trusts, when you are talking about assets that are half the economy? Obviously, you are going to have related parties. When you have $1,000 billion, you have related parties everywhere. On the question of adjustment, it has seemed to me that at the highest level, which is the level to which your subcommittee is raising this inquiry, there has to be some thought as to what is the purpose for having this amount of money. Is the purpose for having this amount of money to secure a pension promise to American's working people?

Now if that is the purpose, think of what constitutes the elements of the pension promise. The pension promise presumably says that a working person will be entitled to some percentage of their preretirement income payable in a currency that sustains its purchasing power for as long as they live. That is the definition of a Government bond indexed against inflation. I make no suggestion that that is the policy that anybody ought to entertain. I simply say, if that is the policy, that is the basic security you would have. On the other hand, people have said, well, one of the reasons that we have this enormous $1,000 billion conglomeration of money is because it provides capital for investment in America.

Mr. Chairman, consider that in 1984, approximately 100 billion new dollars came into the private pension system, and during 1984 major American corporations repurchased over 100 billion dollars' worth of their own stock. So it is very plain that the money that is coming into the investment system is not necessary—is not used for new inventions, new creations. It is frankly, Mr. Chairman, not just a coincidence that the passage of ERISA in 1974 and the beginning of 100-million-share days on the New York Stock Exchange coincide. We are now seeing a pattern of the focus of the components of ERISA investment in major corporations with large capitalizations. And Mr. Chairman, in 1984, the rate of turnover on an annual basis was 70 percent of the assets of ERISA programs. This, to my way of thinking, doesn't bear any particular correlation to value.

So my efforts to provide a frame work to answer your profound question have only served to show how difficult it is and how many different issues are going to have to be raised. What is our specific objective: Is it to create a pool of investment capital? Is it to redeem the pension promise? Is it to be sure that the ownership of the major corporations in America stay American?

Without focusing on those, among other objectives, it's impossible to say why the management stays in outside institutions. It is very clear under the statute why that is occurring. The statute is an extremely comprehensive document. It creates a measure of viability. It raises a number of questions, and yet it makes absolutely clear that is you prudently delegate responsibility, you can also prudently delegate liability.

And as you know, Mr. Chairman, that is a departure from the common law. Before the Congress of the United States in 1974 had the wisdom to pass a statutory common law in this area, under common law, you were not allowed to delegate your fiduciary liabilities.

So the preponderance of American companies have chosen to do this. It is quite incomprehensible to me that they should have done so, because the importance of pension fund assets in corporate management is so large.

I would just conclude, Mr. Chairman, by saying that there are at least two large American companies that, in fact, do retain within house—General Electric and Carnegie-United States Steel—the management and voting of pension securities, and I think with conspicuous success.

I think my suggestions, having to vote "no" to plan sponsors is not, itself, absent significant problems. It is a little difficult under the present context to see how, for example, the General Motors fiduciaries, acting in-house, are going to be able to vote the stock of Ford Motor Co. or a glass company, a rubber company, or an electronic company.

Senator **Cohen**. Or their own stock.

Mr. **Monks**. Or how they'll vote their own stock. We'll have to develop the mechanisms for that, but I think the essence of your question was, if the present situation is unsatisfactory as it appears to be, aren't we forced to look to create new institutions?

My answer to that, Mr. Chairman, is yes.

Senator **Cohen**. My basic concern is that, as you and others have pointed out, there is no incentive compensations under ERISA for superior performance. You are compensated for being safe and prudent. Safety and prudence, to me, would translate into the more stable, larger traditional companies and would not allow much flexibility, for example, to invest in some of the new smaller and perhaps more risky firms.

I think you've raised the issue about superior performance. You can't get compensation for superior performance. In fact, to the extent that you do perform superiorly and earn more money for the fund, you may find that your efforts inure to the benefit of the plan sponsor and not to the beneficiaries. Should the plan be terminated, those excess or surplus assets revert to the sponsor. You then have not worked solely on behalf of the beneficiaries but on behalf of the beneficiaries plus the plan sponsor.

It seems to me that you can't talk about compensation for superior performance without changing the statute. While that is beyond the scope of this particular hearing, it is of concern to me. If the prudence rule leads us to a certain commonality of investment interests, and they all become pretty sure and pretty safe, why do we need money managers to make those decisions and charge high fees, thereby reducing the amount of money that might go to the beneficiaries?

Mr. Monks, Mr. LeBaron, president of Batterymarch Financial Management, is going to be testifying here tomorrow. Batterymarch publicly discloses its proxy votes. Do you believe the Department of Labor should require plan trustees and investment managers to disclose either their policies and procedures for voting shares held by the fund or their actual votes?

Mr. MONKS. I think the Department should do that. In expressing that opinion, I have not expressed an opinion as to whether we have legal authority to do so or not, but assuming we did have legal authority to do so, I think the transparency here—Justice Brandeis was correct when he said "Openness is the best cure for the disease."

It is interesting that there have been studies made in the past. I refer to the one that was done in 1974 by a man named Herman, who studied the voting of bank trust departments. They managed to discover that the bank trust department voted differently on some of the antitakeover type of proposals, Jeff and I have discussed, in cases where there was a significant client relationship, than they do when there is no significant client relationship.

I believe that requiring that the vote be made public would eliminate this particular problem. It might go a long way toward a discipline for the exercise of fiduciary obligations, solely for the benefit of the plan participants.

Senator COHEN. Mr. Clayton.

Mr. CLAYTON. I support the statutory authority to require, on an ordinary basis, that that be disclosed, I think it is an excellent idea.

If fiduciaries and institutions know that those votes would become public, certainly, there would be greater scrutiny. That would also help with respect to the problem of the Department of Labor and its enforcement efforts being able to determine what is going on, because they have no way of knowing.

I do know from personal experience, talking to a lot of institutional fiduciaries, that there are real major conflicts of interest. I can think of one involving one of the largest institutional fiduciaries, the Bank of the United States, where they were talking about having their research department, which came to a conclusion with respect to voting on a takeover issue, making one recommendation and then being in a position, as far as the trustee of the plan, voting a different way. Then their research department was advising their clients, and that is a real case.

Senator COHEN. Mr. Lanoff.

Mr. LANOFF. I'm in favor of full disclosure. It might have a beneficial effect. I represent public plans where the public plans retain the authority to vote their shares with the proxies. I think I prefer that method. I guess I just encourage corporate funds to take back the authority if they have granted it to their money managers to vote their shares.

Going back to your earlier questions and discussions with Mr. Monks, I believe that one of the reasons that Congress in ERISA encouraged pension fiduciaries to delegate their authority and thereby delegate their liability was to assure that adequate expertise and sophistication was available for the investment of plan assets.

During the course of the legislative history developed prior to ERISA, it became quite clear that many fiduciaries were unsophisticated and inexpert and were wasting plan assets as a result of their making investment decisions. I think everyone thought—maybe Mr. Gordon will talk to this, that if they actually encouraged people to delegate it, they would then use their expertise for the benefit of the plans.

While that may work in some areas, perhaps not with stocks anymore where certainly large corporate funds are sophisticated enough in the stock market area, it's still true, I think, in areas like real estate and venture capital. But I think any pension fiduciary has as much sophistication in terms of voting shares on proxy matters as the money managers do. I think that's mostly a matter of commonsense.

You don't have to be a sophisticated investor to understand what corporate activities are going to do to the value of your shares. If someone adopts a poison pill that would prevent any raider from ever attempting to take over the company, you don't have to be an expert to understand that it's going to deprive you of the opportunity to tender your shares in a takeover situation.

So I would encourage corporate funds to take back that voting authority. They've given it up along with the delegation of their authority to invest.

Senator COHEN. What about the Wall Street rule? Is it still firmly established that if you don't like the management, sell your stock?

Mr. MONKS. I think there again, Mr. Chairman, is a place where the new reality imposes itself. It's like the old joke, the man whose broker says, "I've got a wonderful stock for you. Great. Ten dollars will buy it." So they buy 100 shares. The next week he comes back and says, "That stock is now $20. Well, buy some more." "Forty dollars." "Buy some more."

Finally, the guy is around Christmas time. It's now around $80. And he says to his broker, "Sell it." The broker says, "To whom?"

The question here is where the ERISA plans will constitute almost half the market by the turn of the century, to whom are the ERISA plans as a whole going to sell stock?

So the Wall Street rule, as between plans, could work. But, systemically, again, going back to your profound question, what good is it doing the beneficiaries of plans? How is it redeeming the pension costs?

The answer is: Not at all.

Senator COHEN. Mr. Heard, deputy director of the Investor Responsibility Research Center will be testifying tomorrow. The IRRC's recent report to the Labor Department raises a number of questions about shifting voting responsibility to plan sponsors. For example, do plan sponsors, particularly small plans, have the resources to assume this responsibility? Are they less likely to be burdened by conflicts of interest than outside managers? Are they more likely to resolve conflicts in favor of plan participants?

And, finally, if plan sponsors are to assume full responsibility for corporate governance issues, is it important to use employee representatives to assure the interests of plan participants are also fully protected.

How would you respond to those questions? Mr. Monks.

Mr. Monks. It's a very difficult problem. I think the subcommittee has performed a single public service. He's the single person in the country who has made it his business to be best informed. I think we need to develop with a plan sponsor and organization a new mechanism for which there is no precedent. That would be a fiduciary presence.

We have seen in banks with more or less success the notion of a Chinese Wall, in which the fiduciary branch of a bank is presumed not to have access to information that the commercial branch has. I think you're talking about the creation of a comparable kind of either legal or constructive vehicle in which a corporation will have a different persona in exercising its fiduciary responsibilities. I don't think that's beyond the realm of possibility.

We have had convictions of a far more tenuous nature. It's also possible that the corporation might want to create a special purpose vehicle that would exist only for the purpose of exercising the vote. It would have no money management responsibilities and therefore no conflicts.

But I think within that area there is a great deal of room for investigation.

Senator Cohen. Mr. Lanoff raised the issue about some of your speeches last year and earlier this year articulating very serious problems, yet not being translated into policy. In the closing moments of your statement I believe you indicated there has to be some better coordination between the Labor Department and the private sector. Various recommendations have been made about the Labor Department itself issuing some sort of policy statement with respect to these corporate governance issues. In addition, in your prepared testimony, you also talk about how ERISA relates to soft dollars. Should the Department of Labor articulate a policy on these issues in some formal manner rather than through either papers prepared by or speeches given by you or a future administrator? What should the DOL's obligation be to deal with the potential abuse raised by directed brokerage commissions?

Mr. Monks. I think you have your figure on an extremely cogent problem. Mr. Lanoff described it very well. The practitioner, someone like himself who is an expert in the area, can give advice but what does that mean compared to something that has a patina of officiality about it? How do you get the patina of officiality about it?

Unfortunately, you have to go through the whole panoply of the Administrative Procedures Act. In doing that, you come up against a number of problems. They mostly involved in my case, allocation of time.

I think it would be extremely desirable to have in both the area of fiduciary obligation with respect to votes and with respect to soft dollar guidelines if soft dollar guidelines were appropriately within the pension guidelines. Section 28(E) of the Exchange Act of 1934 preempts ERISA with respect to a determination as to what is the scope of the so-called soft dollars.

So, probably, an initial regulation there to monitor the exchanges.

I think, Mr. Chairman, you have also put your finger on another way in which policy could be announced without the cumbersome mechanism of the APA. That would be if you didn't have seven administrators in 11 years, and if there were a sense of continuity, very possibly, the indications of personal involvement by Secretary Brock would go a distance toward that.

I think all of us are very conscious of having had a very interesting job but, frankly, of being low level Federal bureaucrats. If someone at the level of the Secretary of Labor says something, I think it would probably have vastly higher credibility than if an administrator of the Office of Pension and Welfare Benefit Programs, no matter how well-intended or intelligent.

Senator COHEN. Mr. Clayton, you indicated that the Department should direct its enforcement efforts primarily toward civil rather than criminal enforcement.

Of course, as I mentioned, Congress decided that was not the wise thing to do and directed the Department to pursue criminal enforcement as well.

In view of the fact that in 1980, the OPWBP had 255 staff for 589,892 plans and in 1984 it is down to 183 staff for 788,000 plans, and we've cut your budget from $30 million down to $28 million, has Congress itself contributed to the problem of a lack of focus, as well as to a diminution of the Office's resources?

Mr. CLAYTON. I think you have one of the biggest problems I had in responding to the Walsh report, which I thought was a disaster, and a report of really low quality. And I think a lot of professionals in the area agree.

Senator COHEN. You felt the report was a disaster?

Mr. CLAYTON. Yes; it was a disaster. It was basically pressure from the Hill with respect to criminal enforcement. Criminal enforcement is important and there's been some real corruption, particularly the Central States Teamsters is a national example. The Department has done a good job, but essentially you have a gigantic financial industry that you're trying to regulate. And I honestly believe the civil approach, restoration of lost dollars, injunctive relief, is more effective than criminal. I don't think the Department of Labor is really well-equipped to handle criminal investigations. It complicates the system quite a bit because of the problems of self-incrimination and all those kinds of things when you run the civil and criminal investigations together.

And, at the same time, when you're getting fewer and fewer resources and the funds are getting larger and larger, it's hard enough to handle civil. To have to handle the criminal aspects is just that much more difficult, and trying to run a civil and criminal investigation together, oftentimes, you screw up both of them.

Senator COHEN. Mr. Monks, I'd like to come back to you on a couple of major issues. You recommended one solution to the problem of getting exemptions from the prohibited transactions rules would be to have an SRO, a self-regulatory organization. A number of groups have raised questions about an SRO. No. 1, does the Secretary of Labor have the authority currently to delegate that responsibility to an SRO? No. 2, are we creating another layer of bureaucracy? The Secretary would have to retain the power of oversight over the SRO in any event, so are we just creating another level of bureaucracy. Whether or not you could even put together an SRO, there are additional questions raising the issue of having the fox guarding the chicken coop.

In your testimony, you point to the securities field and find that an SRO has been successful there. However, there are questions about whether you could find a commonality of interest in the pension field with so many different groups. Could you find a group that would have the same commonality of interest and be as free from conflicts as one would have to insist?

Mr. MONKS. Mr. Chairman, as to the first point, the Office of the Solicitor prepared for me an extensive legal opinion as to their view of the legality of the Department of Labor under ERISA promulgating SRO. I think you have the Solicitor testifying tomorrow. I'm sure that on your request, he might be persuaded to provide a copy of that opinion.

As far as the commonality question, in my view, the people who should comprise the SRO would be plan sponsors. After all, the questions arise because plan sponsors having money to invest in investment decisions, it seems to me that the plan sponsors rather than the professionals are the people who ought to constitute the SRO.

In suggesting an SRO, I am very much aware of the problem of the fox in the chicken coop. And it's a serious problem. I tend to feel that a very constructive example, a precedent to this, could well lead you to infer an answer about SRO's, that is the present discussion with the New York Stock Exchange, which, as you know, is an SRO, as to whether their listing rules will be weakened by allowing issuers to have nonvoting stock.

There are hearings in the other body. Congressman Wirth has indeed suggested—and I think Senator D'Amato ultimately introduced a bill—what is happening is that while the fox is in the chicken coop, tht is the New York Stock Exchange is regulating itself, the Congress has told the SEC that it has oversight authority over the SRO. Pay attention.

Meanwhile, Congress has had hearings. This is I think the kind of engagement you need in order to realistically deal with that problem. And I think it deals with it well because it makes available for the public interest the expertise of people whose involvement is necessary for successful regulation.

But, at the same time, it assures that the public interest will be secured.

Senator COHEN. I'd like to direct one other question for the time being to you, Mr. Monks. Mr. Clayton would like, perhaps as an alternative to an SRO, to go to the adequate consideration at arm's-length rule, a standard that used to exist. I think Mr. Gordon would argue that it has been tried before. It was the standard ERISA and it is rife with potential conflicts of interest.

If you have a situation now in which you have too few people supervising too many plans under very trying circumstances, what would happen if we adopted an adequate consideration rule? If you're having difficulty now enforcing the rule, wouldn't you have more difficulty enforcing the obligation to show that an individual did not act in good faith or that a transaction was not an arm's length from an enforcement point of view?

Mr. **Clayton**. It took me almost 3 years to make that statement that I made this morning publicly, because I really thought about it a lot. Coupled with that is a substantial shift in burden of proof. And that is, in other words, if you are a party in interest and engaging in a prohibited transaction and you are audited or challenged, you have to show that it was arm's length.

And if you can't meet that burden, then the prerogative transaction penalty would apply. Maybe there's some additional legal gloss that could be put on that. I know it's heresy to say that adequate consideration standard of care doesn't work. But I don't think the exemption process works, particularly in the medium- and small-plan area. The reason why there are only 1,000 or 2,000 exemption requests admitted a year—I don't know what the number is—is who submits exemption requests? People in very sophisticated large plans. You know, General Electric, the Bell Plans, these big, heavy hitters that are well run. They're careful when they do that.

But with respect to the medium- and small-sized employers, nobody bothers to take the time. I find prohibited transactions in plans all the time. The plan sponsors don't know anything about it. And maybe the SRO is a way to go.

I think if you could create an economic interest in the SRO, I mean, members of the National Association of Securities Dealers, have interest as to why they want to be regulated and why they want to stay in the club. You have to create some kind of economic interest in SRO's so that they're going to self-regulate. Whether you can do that, I don't know. But the shift of burden of proof, I think, will go a long way toward the objections to the arm's-length considerations.

Senator **Cohen**. Mr. Lanoff, do you have any comments on either SRO's or shifting the burden of proof on arm's length transactions?

Mr. **Lanoff**. I have to admit, I haven't given it that much thought. This is the first time I've heard Bob Monks talk about plan sponsors as SRO's. That's something I need to think about. I can't weigh it in my mind just sitting here. I thought his notion in terms of SRO's was to have industries such as banking, insurance, whatever, form SRO's and make their views known to the Labor Department.

When I was in the Labor Department none of those groups had any trouble making their views known to me, and I never thought it was necessary to have an SRO, therefore, giving them another opportunity to make their views known to whoever happens to be Administrator or Assistant Secretary or whatever.

As usual, it's an interesting idea. I had never thought of an SRO made up of plan sponsors who were interested in protecting their interests against those who I thought he wanted to form SRO's. I'd like to think about that.

I totally disagree with Jeff Clayton on the arm's length standard. I don't think it worked before and I think that's the reason Congress came up with the admittedly complicated exemption process they came up with for prohibited transactions. But as I said also earlier, I think it's the most effective part of the enforcement program that we have.

Mr. **Monks**. If I could for the record, in the course of our forum, one of the most moving incidents that occurred was the testimony of Senator Javits. We asked Senator Javits precisely this question. I asked him the question Mr. Clayton had told me. Senator Javits excused himself and said he really wanted to think about it for a day, for the rest of the day, while we were having our hearings.

He came down in the evening. He talked to various wisemen, some of whom even had changed their minds, who had earlier advised him. Senator Javits' worries have stayed very much on my administrative soul. He said we're dealing with a very great evil here; never forget we're dealing with a very great evil. And Senator Javits said that he thought that the statute should not be amended.

Senator COHEN. Let me turn from the focus of evil.

Take your mike and pass it to Ms. Brown.

Ms. Brown, I'd like to focus on the 5500 form. Tell us what types of plans participated in the pilot project that Mr. Monks mentioned.

Ms. BROWN. Mr. Chairman, we were very lucky to have a very broad range of plans that participated and a broad geographical distribution of plans.

There are many large, many medium, and a lot of small plans. Some were submitted by plan sponsors, some by untraditional service providers such as their attorneys, some by traditional service providers who currently fill out and retain records for 5500 production for a lot of small plans, whom I'm sure you can imagine don't really have the capacity to do a lot of paperwork in their home offices. There were, therefore, different needs that those participants had as far as what they wanted out of the pilot.

But I think it's fair to say all of them are enthusiastic and thought it was worth their while.

Senator COHEN. I would like to direct a general question to all of you. It's my understanding that in order to reduce the paperwork burden, the 5500 form has to be filed only with one agency, instead of three. That is the IRS. It takes about 7 months, as I understand, before the IRS completes its processing of the forms. Then it takes about 2 or 3 months beyond that before it ever comes to DOL.

If, in fact, the IRS finds there's insufficient or incomplete information in the 5500 form, the new information that is then supplied to the IRS never comes to DOL. So you have a problem not only of delay but you also have one of the form being incomplete.

The question has been raised as to what degree is this information even necessary for enforcement under the act. A number of questions have been raised that the information requested is not necessary and that perhaps before we go to a new system of electronic filing, we ought to determine whether or not the Government is going to continue to insist that the form be supplied.

Mr. LANOFF. I would agree that the new form does need some reformulating. It was basically drafted in 1975 and, of course, in the 9 or 10 years since then, the enforcement people at the Department of Labor and IRS have learned a lot about enforcement. I'd like to see the expertise they've developed built into new questions that they might put on the form.

Just before I left the Labor Department we reformulated the 5500C, the reports that are required of smaller plans, and we built in some of that experience and knowledge. I think some of the questions on 5500C that now go out to small plans are far superior to the questions that still go to the bigger plans.

Senator COHEN. Ms. Brown, what would it cost for all plans to file 5500's electronically? Do you have any estimates on that?

Ms. BROWN. The Government or private sectors?

Senator COHEN. Both. Mr. Monks indicated it costs about $120 million for the private sector to supply the information. What would it cost the Government and the private sector to file the forms electronically?

Ms. BROWN. The estimate we have, Mr. Chairman, on the Federal side is that a $25 million system could be set in place over 5 years that would service all three of the agencies that were named in the testimony as well as the Social Security Administration, which uses a part of the 5500 data.

On the private sector side, we do not have a hard figure of how much money it would save; but suffice it to say that our best estimates are that over 90 percent of the filers currently retain their information on computers and all that they would need to do is take it off in one of several set formats and send it in. So, in a sense, by definition, you've saved a big chunk of that production time.

Senator COHEN. What has been the OMB and IRS's attitude toward electronic filing?

Ms. BROWN. The OMB was very cooperative and did establish a working group last December of the concerned agencies to see whether or not this wasn't something that was cost-effective and shouldn't be followed through on. The IRS understandably is dealing with a bottom-of-the-barrel priority in processing the 5500 forms. In candor, I think that they would admit that it's a pain in the neck for them as well as inefficient for the system.

What we have proposed for them to consider—and I would hope that it could move forward—is getting an outside contractor the way the SEC has done, who would process these in a very cost-efficient method for all four of those agencies.

Senator COHEN. Mr. Clayton, do you agree with Mr. Lanoff, and I'll ask Mr. Monks as well, that perhaps we ought to revise the 5500 form to change the information that is requested to make it more effective?

Mr. CLAYTON. Absolutely.

Several pages of my testimony deal with the need for a scientific analysis of the 5500 form from an enforcement perspective and from a regulatory perspective. It's an old form that was put together on the basis of no experience and clearly a good scientific analysis of that form, particularly as it relates to enforcement, ought to be made.

Mr. MONKS. Mr. Chairman, again, from our forum, a particularly intelligent witness, Mrs. Charlotte Armstrong of Peat, Marwick & Mitchell, said it was an intellectual exercise. She'd gone through the form 5500 and compared it with the idea of rejecting what was the conventional wisdom which said it was trash. And she had found that there was nothing on the form 5500 that was not specifically required by statute and that therefore the problem will be one of amending the law and there is not administrative discretion in this area.

Mr. **Lanoff**. That comes from an accountant, not a lawyer. I'm not sure I agree with that.

Mr. **Monks**. She's a graduate of Harvard Law School.

Mr. **Lanoff**. I'm not, but I still disagree with her. The only reason I'm saying that is because when we looked at the 5500C, that was the initial reaction of the legal staff. Again, upon reflection, they came back with a different answer.

Senator **Cohen**. I'm going to take this time to thank all of you for appearing.

Mr. Gordon has been waiting patiently in the first row. I would like to complete this morning's hearing with Mr. Gordon's testimony and to thank all four of you for spending so much time trying to clarify some of the problems that are involved in a very dramatic way with this most important program. We thank you.

[The prepared statements of Messrs. Monks, Clayton, and Lanoff follow:]

Statement by
Robert A.G. Monks
Former Administrator,
Office of Pension and Welfare Benefit Programs
United States Department of Labor
before the
Subcommittee on Oversight of Government Management
Committee on Governmental Affairs
United States Senate
June 25, 1985

Mr. Chairman, my name is Robert Monks. From December, 1983 to January, 1985 I served as Administrator of the Office of Pension and Welfare Benefit Programs at the U.S. Department of Labor. I am delighted to appear before you today and grateful for the Subcommittee's interest in this subject. I know the hearings you are holding will provide a constructive examination of the enormous growth of private pension plans and the government's role in overseeing them.

Let me start by saying that I sincerely hope these hearings will serve to assist Secretary Brock and his senior staff in administering ERISA. I have great personal and professional admiration for the Secretary, and I know his tenure at the Labor Department will benefit all the programs under his supervision. Nothing in my oral or written statements should be construed as criticism of the Secretary or his agenda; since I resigned from the Department before his nomination, all my experience in the pension office occurred in a different Labor Department administration. I hope that the work I undertook last year, which I will discuss today, might be a useful resource for the Secretary and his appointees.

I would also like to note that my comments relate to structural problems. The career staff of the pension office with whom I worked are absolutely first-rate. They are dedicated, able individuals who are confronted with an impossible task. The size of their responsibilities, however, has never daunted their commitment or their performance. I admire them greatly, and know that my successor will be well served by their expertise.

I will begin with a brief overview of the Employee Retirement Income Security Act of 1974, commonly known as ERISA. This law governs all private pension plans; while the creation of a private pension plan is voluntary, if an entity does choose to set one up, it must conform to ERISA guidelines. Chief among these is the designation of a trustee who is responsible for ensuring that pension plan assets are managed exclusively for the benefit of plan participants.

ERISA has encouraged the establishment of more than 900,000 pension plans. Their assets now total approximately one trillion dollars, the biggest single pool of capital in the world. It is estimated that ERISA funds own almost one-third of the equity in publicly traded U.S. corporations and one-half the debt. It is projected that they will own half the equity by the year 2000.

As is evident from these statistics, ERISA's impact is vast. There is no major financial transaction, nor any corporate takeover, that doesn't involve ERISA funds. As recent media coverage indicates, people are only beginning to understand the pervasive effect of this huge amount of money. Certainly, some of its effects were foreseen by the members of Congress who drafted the Act. Some were not, and indeed, could not have been. There are at least four major consequences that ERISA sponsors could not have contemplated.

The first of these is the sheer size of plan assets: one trillion dollars. Since the right to vote shares of stock is in itself an asset, the trustee's fiduciary responsibility extends to the vote as well. This means that the trustee is obligated to vote plan assets according to the best interests of plan participants, which has resulted in making ERISA funds a major factor in governance decisions affecting corporate America. Recent takeover activity has highlighted the pivotal role that pension plans can play in a contest for votes.

Second, ERISA requires that assets be managed "prudently". While prudence has never been easy to define, it is clear that the more experts who can be found to ratify the wisdom of a certain investment decision, the more it will be deemed to have been prudent. ERISA has therefore actually encouraged delegation of fiduciary responsibility by the plan sponsor to outside experts. Most often the delegatee is a bank, an insurance company, or a securities dealer. Given the competition for lucrative ERISA business, these fiduciaries must demonstrate superior results in order to retain clients. Often this entails bringing in their own experts to measure performance in a way that shows optimum results. The result has been the creation of a very large, and profitable, ERISA industry.

Third, the size and coverage of ERISA plans has forced consideration of an issue that the Act's sponsors did not address: namely, what is U.S. pension policy -- or do we even have one? There is no explicit understanding of how private pension plans relate to the other two components of retirement income -- savings and Social Security. Even within ERISA, there is no basis for judging whether the present ratio of defined contribution to defined benefit plans is proper. On a larger scale, we don't know whether the benefits of ERISA warrant its costs. In an age of unprecedented budget deficits, it must be recognized that ERISA contributions are the biggest single corporate tax deductions taken -- yet we don't know whether real retirement income is actually being produced for workers. ERISA's annual cost to the government is somewhat in excess of 43.2 billion dollars a year. Whether the results justify the cost is not known, since there are no policy objectives against which to measure performance. In short, we don't know whether the objective of secure retirement income is being met at all, and if so, how well.

Before I get to the fourth consequence, let me underscore that because the first three were unintended -- the size of ERISA funds, the size of the industry, and the absence of national pension policy -- no one is responsible for them. There is no executive branch office nor legislative committee with oversight duties relating to any of these areas. The one common denominator to all three is the management of pension assets, which should logically be a concern of the Department of Labor's. If this is the case, the pension office should hardly be seen as a mere issuer of exemptions, but rather as a specialized financial agency with the need for capabilities similar to the Securities and Exchange Commission. This would have major implications for the way the office is organized and the kind of people who would be included on its staff. But since no one foresaw that ERISA would have such consequences, no one thought to provide for them. These are not insignificant developments. As a part of its deliberations, this Subcommittee ought to consider who should be responsible for their oversight.

Finally, the administration of ERISA was divided among two executive branch departments, and three agencies within those departments. I will speak only about the agency which I ran in the Labor Department, the Office of Pension and Welfare Benefit Programs (OPWBP). This office, which is charged with the administration of Title I of ERISA, has five programmatic functions: reports processing; enforcement; exemptions; research and policy; and administrative activities, including answering public inquiries for assistance.

I will focus on the first of these, reports processing, to illustrate the total disfunctionality that is the result of efforts to administer this law. It is so complete as to render the word "unintended" a joke.

Each ERISA plan must file an annual report with the Federal Government. The report form, known as a Series 5500 form, is roughly six pages plus appendices, which can be quite long. It requires a wide range of information on any given pension plan, which, depending on the size of the business, can include detailed entries on plan participants, no fewer than one hundred lines on plan assets and liabilities, a certified accountant's opinion, and names and identifying information on any contractor who serviced the plan. Currently, the 900,000 forms submitted each year are completed by hand. Once they reach the government, a lengthy and expensive process starts in which all the 5500 data are manually key entered on computer tape. Without dwelling on the rather painful details of this system, let me summarize it by saying that by the time ERISA data reaches the Labor Department, they are full of errors, incomplete, and up to several years old.

I know it is not uncommon to hear that government information systems are inadequate, outdated, and painfully slow. But consider what it means to have no current, and only incomplete historical, data on ERISA plans. It means no one knows anything about the biggest single lump of capital in the world. It means there is no way to even start to assess whether the program is cost-effective because no one can measure the benefits. In programmatic terms, consider what it means in an office where every single function turns on information. It means that enforcement staff must base their investigations on newspaper articles and phone calls -- because by the time they have access to 5500 data, the statute of limitations has usually run. It means that the research staff, who are charged by the law with conducting studies that will serve as the basis for pension policy recommendations, are making so-called "forecasts" from material that is several years old. Considering the imposition that is placed on the private sector to assemble this information, if this is the best use to be made of it, it ought not to be required at all.

It is unthinkable to contemplate the Internal Revenue Service or the Securities and Exchange Commission basing their enforcement efforts on financial data anywhere near as inadequate as that for ERISA; effective enforcement depends on the systematic review and audit of annual filings. Indeed, to a great extent compliance with any law turns on some degree of public belief that if a federal return is required, someone in the government will open that return, read it, and act on it if warranted. No such belief whatsoever exists in the ERISA community, as we have heard directly from many of those who fall under its enforcement provisions. To what end, therefore, this charade? Every year, the executive branch spends between ten and twenty million dollars and one hundred full-time staff years to process ERISA data. Every year, it is conservatively estimated that the private sector spends one hundred twenty million dollars just filling out 5500 forms. Yet the end result of the entire process is useless information, and disfunctionality in the programs that depend on it.

In your letter of invitation, Mr. Chairman, you asked several specific questions which I will address now. With regard to the priority given ERISA by the Department of Labor, let me applaud Secretary Brock's decision to elevate the Administrator's status to that of Assistant Secretary. That is in and of itself a big step forward. It is also vital that the pension office be given the additional support necessary to function as a professional organization. This means giving the pension office its own budget as a line-item; making it possible for appropriate legal help to be hired; and promoting the professionalism of the office in a way that will attract high-quality candidates to its staff. None of these can be accomplished without the complete support of top-level Labor

Department officials who understand the resource needs of the pension program. There is no question that during my tenure at the Department there were not sufficient resources to administer the law effectively. My written submission contains detailed reviews of current resource levels and recommendations for enhancement and re-allocation.

With regard to enforcement, I will repeat that as currently carried out, ERISA enforcement efforts are extremely meager. During my tenure at the Department, I convened the Enforcement Task Force, which included senior legal and pension office staff. The Task Force was charged with a thorough review of the enforcement function; its report, which I have included in my submission, supports the conclusion of several Congressional inquiries that at no time since the passage of ERISA have adequate resources been devoted to enforcement. The report contains specific recommendations for improving enforcement efforts.

I have mentioned the critical need for better information on ERISA plans. Clearly, given the constant growth in pension plans, there is no way the Department can ever get on top of the statistical problem by dealing with paper-based reports. The use of computer technology is the only cost-effective approach. While I was at the Department, we designed and ran a pilot project to test the submission of annual report data on computer tape. The pilot was a great success, and showed that significant time and money can be saved by both the private and public sectors if a transition is made from paper forms to computer tape. We know that the majority of all filers retain their report information on computers; we know the government can process computer tape; and we know that using computers can give the Labor Department, the Internal Revenue Service, and the Pension Benefit Guaranty Corporation -- the three agencies who use ERISA data -- timely, accurate, and complete information, none of which is now available to anyone. I regret to say that while the pilot was successful, the pension office, as of my latest information, did not have the Department's approval to spend any more money on developing a full-fledged electronic filing system. As of this month, the funds will run out. And a government-initiated solution to an enormous paperwork problem will die for lack of follow-through.

With regard to the prohibited transaction process, current efforts barely keep pace with the mailbags. The pension office receives between 600 and 900 applications each year requesting approval for some ERISA investment that falls outside of the traditional categories specifically authorized by the law. This was anticipated and accommodated by the statute in setting forth an exemptions procedure. What was not foreseen was that the flood of exemption applications, time pressures, and meager support would put the Labor Department staff at a distinct disadvantage in trying to keep up with the creativity of Wall Street. There is no limit to the sophistication and novelty of financial schemes that ERISA money managers develop. It is unrealistic to think that anyone outside the core of the financial community has ongoing access to the detailed financial skills that are necessary to evaluate the exemption requests that come into the pension office. One sensible solution, which can be implemented within existing resource constraints, is to create a self-regulatory organization (SRO) that could augment the Department's staff with a privately-staffed and funded source of expertise. There is precedent for the use of such an SRO, including the National Association of Securities Dealers and the Financial Accounting Standards Board. In December of last year, we published a Federal Register notice soliciting comment on the concept of an SRO; responses were generally positive, and many of those who commented expressed their willingness to work with the Department on a joint task force to pursue the study and possible creation of an SRO for the ERISA exemptions process. A summary of those comments is included in my written submission.

Your letter also addressed the question of fiduciary responsibility under ERISA. Again, I will take the liberty to submit for the record an article written for Barron's that sets forth the primary problem that has arisen in this area. Let me briefly summarize it by describing a hypothetical takeover situation.

Bear in mind that ERISA plans must be invested and managed for the "exclusive benefit" of the plan participants and beneficiaries. This requirement encompasses the exercise of voting power every bit as much as the investment power. But consider the dilemma this poses for major ERISA money managers: the banks, insurance companies, and securities conglomerates. Let's take the hypothetical Company A, whose ERISA funds are managed by Bank B The Bank also manages pension portfolios for ten other large companies, and has purchased Company A stock for all ten. Enter Company A's pension officer one day, with an additional ten million in pension funds for the Bank to manage, and coincidentally, a small request. Company A's annual meeting is coming up, and a certain anti-takeover measure is on the proxy; Company A surely would appreciate it if Bank B could make sure all the proxies it holds are voted the right way. Needless to say, the Bank justifiably worries about keeping Company A as a valued client. But it also holds trustee responsibility for ten other pension portfolios, whose best interest may well lie in Company A being available for acquisition.

Are such exchanges taking place? In the Wall Street Journal of May 10, an unnamed money manager was quoted as saying that he in fact had received calls from Unocal officers on exactly this issue. When one considers the few large entities that control the bulk of pension fund assets -- in 1984, the one hundred largest companies owned more than half the assets -- it is clear that there are extensive overlapping networks of "connected" companies who have commercial relationships with virtually every significant financial service provider.

The number of phone calls that could be arranged to a fiduciary with an "unacceptable" view of exercising his responsibilities boggles the mind -- it is a very large number.

I believe it is vital that the Department of Labor work with the private sector to promote better understanding and fulfillment of fiduciary obligations. To some extent, these obligations are neglected out of ignorance -- to some extent, they are neglected out of the almost certain knowledge that the pension office is not equipped to effectively enforce the law, so that wrongdoers need not fear being caught. But again, awareness and self-regulation by the private sector are the only solution. There is no need for further regulation; there is no need for more laws. ERISA is sufficiently comprehensive to offer whatever guidelines are needed.

As I have said, there are detailed recommendations in my written submissions on all of these issues. I hope they will be helpful to the Subcommittee in these hearings, and to Secretary Brock and his appointees in their agenda for the Department. For the record, let me simply list those documents which I have submitted. They include: the Administrator's Annual Report to the Secretary, which contains the Enforcement Task Force Report, the report of the National Pension Forum, electronic filing pilot materials, and long-range plans for all the components of the pension office; the summary of hearings held in January, 1985 on corporate governance; a summary of SRO comments received pursuant to the Federal Register notice; and the Barron's article.

Let me close by saying that there are two separate levels of ERISA consequences that bear examining. The first is the fundamental change that has occurred in the nature of capital markets as a result of the massive size and presence of private pension fund assets. We can watch market movements, corporate takeovers, and huge daily trading volumes on the exchanges and see what the financial repercussions of one trillion dollars are. What we cannot do is measure their relationship to guaranteed retirement income for American workers, the objective for which ERISA was passed. On the second level, we can comprehend that the government's administrative responsibility for this enormous program has become even more critical than the original sponsors could have envisioned, simply because of the unintended consequences. Yet the resources committed to the administrative task as it is now understood are not its match. If ERISA's goals are still worthy, we owe it to those covered by its provisions to administer the Act seriously. I hope the Subcommittee will include both levels of discussion in its deliberations.

That concludes my remarks. I would be happy to take questions now or after my co-panelists have spoken. Thank you Mr. Chairman and members of the Subcommittee.

PREPARED STATEMENT OF JEFFREY N. CLAYTON

Mr. Chairman and members of the Committee, thank you for the opportunity of appearing before you today to express my views on many aspects of the Office of Pension and Welfare Benefit Programs, U. S. Department of Labor (hereinafter referred to as "OPWBP"). It is an honor to be able to appear before you, and I hope that my comments will be helpful in your task of overseeing government management.

For ease of reference, I have broken my testimony down into subject headings which are indicated in the text of this document. Before I get into the specifics of my testimony, I will first state a little about my background and tenure with OPWBP and then address the important subject, the Pension Program at the Department of Labor.

I. IMPORTANCE OF OPWBP.

The importance of OPWBP to the government, the workers of America, and the economy in general cannot be overstated.

Employee benefit plans have become the single largest source of private capital in our economy. An increasingly greater share of the capital stock of the major corporations of America are being purchased and owned by employee benefit plans. We are rapidly approaching the day when employee benefit plans will have over a trillion dollars of assets.

With such an enormous capital pool, the regulation of employee benefit plans, cannot help but have a substantial impact on our economy. I believe the thrust of that regulation, should be to allow plans the greatest possible flexibility in their choice of investments so as to allow the marketplace to direct where private capital will go.

At the same time, a major portion of the future security of millions of Americans depends on the security of such plans. In the past there have been many incidences of corruption and economic irresponsibility concerning these funds which are so vital to the security of so many of us. Accordingly, any regulatory policy must balance the two sometimes competing goals: (1) assuring a free flow of private capital from plans into the economy, and (2) maintaining the security which American workers deserve.

As my testimony will reflect, it is ironic that an industry so large as the pension industry commands so little attention from the government and receives such a minuscule allocation of resources in comparison to the scope of the regulatory task.

II. PERSONAL BACKGROUND.

I came to the Department of Labor in May of 1981. I became involved in the affairs of OPWBP early on and was appointed Administrator of the program in November of 1981. I resigned from that position on September 14, 1983.

Prior to joining the Department of Labor, I was a partner in a Salt Lake City law firm practicing mainly in the business area with an emphasis on labor law and the law regulating the employer-employee relationship.

Currently, I am a partner in a Salt Lake City law firm with a specialty in employee benefit plans, particularly emphasizing fiduciary standards and compliance with ERISA.

III. STRUCTURE OF OPWBP.

To better understand the current structure and the problems which OPWBP faces, it is helpful to review briefly some of its past history. But, first I would like to compliment the staff of OPWBP for their excellent work. Some of my testimony today may be deemed to be critical of OPWBP. My criticisms are directed more at structure and procedures than at the personnel themselves. When I first began working for the government, I had a view too often held by many outside of government, that most government workers were lazy nine to five bureaucrats who sat around thinking of things to make life difficult for the rest of the public. My views quickly changed when I discovered the quality and dedication, particularly of the professional staff, at OPWBP. Many of those that I worked with, have the training and ability to make them successful in any aspect of our economy, but for various reasons them have chosen to be public servants, often at a substantial financial sacrifice.

I have great respect for the staff of OPWBP and strongly feel that they have accomplished a great deal, particularly in light of many of the adverse circumstances under which they have had to function.

In OPWBP from the beginning, there has been a debate between the criminal enforcement advocates (the gum shoes) and those advocating a primarily civil regulatory enforcement program similar to the Securities and Exchange Commission or civil enforcement at the Internal Revenue Service. The gum shoe advocates are primarily old line Department of Labor people, many of them from the old parent agency of OPWBP, the Labor Management Services Administration. There has been constant bureaucratic infighting over the years as the gum shoes tried to obtain dominance over the newer OPWBP staff members, particularly those who were transferred from the Internal Revenue Service under the 1978 reorganization order. As a result, over the years the enforcement strategy has waved two and fro from a greater emphasis on criminal enforcement to a greater emphasis on civil enforcement. During the time I was Administrator, LMSA proposed that the OPWBP investigators be given the authority to carry fire arms and conduct more FBI criminal type investigations.

I attribute no bad motive to the criminal enforcement advocates, who honestly believe that this is the most important way to enforce the pension laws. Nor do I deny that there are criminal elements in some employee benefit plans. However, OPWBP is not well equipped to conduct criminal investigations whereas the FBI and Department of Justice are. In addition, conducting civil and criminal investigations on a parallel basis creates substantial legal problems which can severely damage either civil or criminal aspects of the case unless careful safeguards and often cumbersome restrictions are imposed upon the investigators.

In my view, and in the view of most members of the employee benefits community with which I am familiar, the Department of Labor ERISA enforcement should be primarily civil. The major task confronting OPWBP is the regulation of a giant industry involving billions and billions of dollars. Although there are criminal elements which must be dealt with, the limited resources of OPWBP can be more effectively directed towards primarily civil enforcement. In many respects, OPWBP is primarily a regulatory program with a strong emphasis on enforcement but with the ultimate aim of regulating the conduct of members of the employee benefit community.

I believe as a general rule, the civil remedies such as enjoining "bad actors" from being plan fiduciaries and restoring to plans losses which have been incurred as a result of illegal conduct is much more effective than going through the difficult process (given the burden of proof in criminal actions) of incarcerating those who are guilty of criminal violations.

I would hope that by stressing civil enforcement in the Department of Labor, it would not mean that the Department of Labor or the Department of Justice would turn its back on important criminal prosecutions which must be brought. Through the sharing of information, and cooperation with the FBI, the Department of Justice and U.S. Attorneys around the country, the Government can deal with the insidious problem of criminal corruption in employee benefit plans.

A second problem which plagued OPWBP over the years was the loss of resources to its parent organization, the Labor Management Services Administration. When OPWBP was originally funded, Congress specified the number of super grades to be allocated to the program. Immediately, LMSA began taking those positions for their own use, supposedly as administrative personnel with substantial responsibility for the pension program, but in reality much of that valuable resource was drained into other LMSA programs. The same occurred throughout various levels of OPWBP.

OPWBP also suffered in the politics of the Department of Labor because it was a small program in a large department whose head, the Assistant Secretary for LMSA, was usually not, and to my knowledge never was, expert in ERISA. As a result, the head of the program usually had greater interest in other LMSA programs and so OPWBP often had little representation of its interests unless the Administrator was fortunate enough to have direct access to the Secretary. Perhaps an example of one of the problems that I had would be illustrative.

We were able to obtain for OPWBP, a budget allocation to do initial studies on the 5500 and the possibilities of computer targeting in connection with the analysis of the 5500. The proposal, as submitted through the budget process, was to allow OPWBP to hire or contract with experts who could help design a statistically sound analysis of successful çases and the 5500, to determine whether there were statistically significant correlations between the information reported on the 5500 and successful enforcement cases. This was intended to be a first step towards developing some scientifically sound computer targeting. When it came time to spend the money, LMSA took the budget allocation to buy computer hardware which had some benefit to OPWBP but was primarily designed to support the field administrative bureaucracy of LMSA.

Another substantial problem which OPWBP faced was the lack of line authority over the field staff with the resultant inability to provide a uniform enforcement regulatory structure. The Administrator was given the responsibility for enforcing the law but he had no authority to direct the way that policy was implemented by the field. In addition, because of his lack of authority over the field, he was unable to coordinate regulatory policy with enforcement policy.

Enforcement was further complicated by the lack of clear delegation of authority between the Solicitors Office (SOL) and the program. At one point in time, the decision as to which cases were to be brought was made exclusively by SOL. At another point in time, allegedly that authority was given to the program. However, it was never really clear whether that authority did really rest with the program or whether SOL was merely acquiescing in those decisions. This lack of clear delegation of authority created problems with the field staff who would often spend many hours developing cases, only to find that the cases would not be brought because the attorneys didn't feel that it was an appropriate case. This created disappointment among the field staff.

It should not be interpreted that the SOL was antagonistic to the program. Much of the support the program has received has been through the resources of the SOL's office and SOL's willingness to dedicate large budgetary allocations to the prosecution of expensive, complex litigation involving employee benefit plans.

In short, for much of its history, OPWBP has had many dedicated professionals who have been swimming upstream against a current of internal departmental politics which has sapped much of its energy.

I have taken a moment to dwell on some of the problems of the past to point out that those problems were indeed very real and very detrimental to the program. Hopefully many of the great improvements which have come as a result of independent status of OPWBP will be maintained, rather than having the program revert back to its old structure.

Clearly, the new independent structure of OPWBP is a tremendous improvement over the past. Many of the problems outlined above have been substantially remedied. With further work more problems can be remedied in the future. There still remain some current program problems which should be addressed.

The head of OPWBP ought to be elevated to the level of an Assistant Secretary. This would give the program a better chance of being effective in its struggle for influence, resources, and prestige within the Department. Given the importance of the program and the vast resources which it affects, the elevation of the Administrator to a position of Assistant Secretary is warranted.

Elevation would also help with coordination with other agencies. As you are aware, particularly in Washington, the amount of cooperation one receives as a government official is directly proportional to the status that others perceive you have. The other two agencies, IRS and PBGC, with which OPWBP has to coordinate are both headed by persons with substantially higher status within their organization, PBGC as the head of an independent corporation and IRS as an Assistant Commissioner.

It would facilitate better coordination among the agencies to give the head of OPWBP a higher level within its department.

The implementation of line authority over the field has and will contribute immeasurably to the success of the enforcement program. So will be removal of OPWBP from LMSA. Hopefully as an independent program, OPWBP resources will not continue to be eroded by other agencies as they were with LMSA.

With respect to the relationship between the program and the SOL, there has been great improvement in the past years. SOL has attempted to create a true attorney-client relationship. However, it ought to be made clear on a more formal basis that the program really is the client and it determines which cases ought to be brought. This is important because of the effect of case selection upon morale of the field staff.

SOL should be complimented for its willingness to use its resources to litigate expensive cases. The use of the resource of regional solicitors to bring smaller cases should be encouraged. Hopefully if this program continues, there will be greater enforcement on small to medium size plans, an area where little enforcement has taken place.

Another item, which affects the relationship of the program to SOL is the need within OPWBP for Schedule "A" hiring authority. ERISA is an immensely complex statute which requires the skills of trained lawyers to interpret. In order for the program to function effectively, it needs to be able to hire lawyers. To be able to compete for legal skills and be given the flexibility to deal with lawyers, it needs Schedule "A" hiring authority.

Schedule "A" hiring authority has always been jealously guarded by SOL. Understandably, the Solicitor has been reluctant to allow such authority to exist outside of his office. Clearly, we do not want a duplication of effort in the program and SOL. With appropriate coordination, Schedule "A" hiring authority could immensely aid the program in accomplishing its tasks while not infringing on the prerogative or duplicating the efforts of a SOL.

IV. ADEQUACY OF RESOURCES.

Given the immensity of the universe, the resources of OPWBP are grossly inadequate. To give you an example of the immensity of the task, if OPWBP were to randomly audit every employee benefit plan in the United States, it would audit each program approximately once every 2000 years. Realistically speaking, given the current budget climate, it is not likely that any major influx of resources into OPWBP will be forthcoming. Because of the dim prospects for major funding increases for the program, attention should first be focused upon helping the program do better with what it has. I think this improvement can happen in two areas with some additional funding but not dramatic increases in budget. These areas are training and computer targeting and related computer support.

Nowhere is the inadequacy of funding for OPWBP more apparent than in the area of computer targeting. The IRS recently completed a TCMP for employee benefit plan returns which took several years to complete and cost millions of dollars. DOL, as mentioned earlier, was given $500,000 some years back which never really made it to the development of computer targeting.

During my tenure with OPWBP, almost all cases which eventually were investigated were selected by hand from a review of the 5500. Some narrowing of the selection process was done through selecting 5500's by geographical area or in some cases 5500's which had unusual amounts of real estate or something of that nature. However, such narrowing of the selection process was done by crude means at best and most of the work was done by hand. Given the large universe, any meaningful impact the enforcement program wishes to have upon the employee benefit industry will have to involve the use of computer targeting.

Over the years OPWBP has attempted to obtain funds for computer targeting and has had difficulty. Resistance to hiring of outside contractors who could actually do the job substantially cheaper than the inhouse computer were constantly thwarted for internal political reasons. The resistance to upgrading the computer targeting capabilities of the program within the Department have to be overcome. Funds have to be appropriated to allow OPWBP to do a scientifically and statistically sound analysis of the 5500 as it relates to enforcement procedures in order to create some type of meaningful computer targeting system.

An upgrading of training of the field staff would also aid the enforcement and administration of ERISA. There has been little money over the years to provide really professional training to those persons who have to audit employee benefit plans. Because of the relatively low entry level of the field investigative staff (GS7), training is critical in order to upgrade those very basic skills to provide a meaningful enforcement program.

Currently, there is little meaningful enforcement of ERISA. After spending a year and a half in the private sector representing clients and dealing with other professionals in the employee benefits field, my impression is that most people either don't know or don't care about the Department of Labor enforcement of ERISA.

Ironically, we have created a situation through the enactment of ERISA and the establishment of OPWBP which may breed major problems in the future. That is plan fiduciaries can say to the world, "Don't worry about us, we are regulated by a strict statute so leave us alone," while in reality, they are poorly regulated and for the most part are free to do what they wish.

As a private practitioner, it is immensely frustrating to advise a client as to what the law requires and what procedures must be followed, usually at some cost, when most of its competitors ignore the law with impunity.

A meaningful computer targeting program and an upgrading of the field staff through really professional training would certainly be a step towards making the Department of Labor's enforcement presence more meaningful.

V. ENFORCEMENT STRATEGY.

I am not aware whether any enforcement strategy under the new head of the office of enforcement of OPWBP has been formulated. As is clear from my prior testimony, ERISA enforcement from the Department of Labor's perspective ought to be that of a civil regulatory program. Coordination must occur between the exemption, regulation, and advisory opinion sections, and case investigation and prosecution resulting in a unified approach which can best curb abuses in the employee benefits community.

The use of regional solicitors expands the impact of the program and hopefully will give OPWBP the opportunity to be felt in the medium and small size plan area, an area which to date has felt very little regulation. It is also an area which, I know of my own experience, has some of the greatest abuses.

VI. 5500 REPORTS.

As Administrator, I received a lot of complaints with respect to paperwork burden of the 5500. I am informed, that it is one of the largest single paperwork burdens which originates from the Department of Labor. If such is the case, the public's concern with the amount of time it spends filling-out the 5500 is certainly justified.

I don't think anyone really knows how effective the 5500 is as an enforcement tool compared to how effective it might be. It is the single most essential enforcement tool which the Department of Labor has and accordingly must be protected. There is almost no knowledge as to what information on the 5500 is important to enforcement and what is not. Just prior to my becoming Administrator, the Office of Enforcement did a survey of investigators to determine which elements of the 5500 they felt were most important. The response was varied and there was little consistency. The only real consistency was a statement by most investigators that they would like more information.

A scientific analysis of the 5500 is critically needed, to determine what correlation exists between information reported on the 5500 and the apprehension of violators of ERISA. No such study has ever been completed. Before any meaningful review of the 5500 can be done, such a study should be made.

Much valued information for statistical purposes does arise from the 5500 and has been used in numerous studies by the Department of Labor and private pension groups. When a study of the 5500 is undertaken from an enforcement perspective, input should also be received from the academic community and others who utilize pension data to make important projections dealing with this vital sector of our economy.

Another major problem with the use of the 5500 by the Department of Labor is that it does not receive the information contained in the 5500 until long after it is filed with the government. By law, the 5500 is filed some seven months after the plan year end, which in most plans means July of the following year.

Usually the Department of Labor does not begin receiving those 5500's from the IRS in meaningful numbers until the following Spring. As a result, by the time the 5500 information reaches the Department of Labor, it is already a year old and by the time the cycle is complete, it is two years old. Department of Labor investigators are put in the embarrassing position of having to go to the plan which they are investigating and first asking for a current copy of the 5500 because it is not available through their own channels.

Every year the IRS promises to make the reports available on a more timely basis, and to my knowledge, that promise has never been fulfilled. The IRS does do a great service to OPWBP by obtaining the hard copy of the report and processing it into magnetic tape and supplying hard copies to the Department of Labor. The process, however, is at best cumbersome and at worst incredibly slow and inefficient. The use of the 5500 as an enforcement tool would be greatly enhanced if a more efficient system could be created which would allow the Department cf Labor to get more data on a timely basis.

VII. PROHIBITED TRANSACTION EXEMPTION PROCESS.

Early in my tenure as Administrator, I made a decision, which I have come to regret, that the best way to handle the prohibited transaction exemption problem under 406 and 408 of ERISA was to adopt broad class exemptions which would facilitate beneficial transactions which otherwise violate section 406. We certainly made some progress in the creation of broader relief under the class exemption process, but the inroads were small.

Currently, if a party needs relief under the section 408 exemption process, it takes a minimum of 3 to 6 months, with 3 months being a very optimistic estimate. Such a time frame is not realistic within the confines of ordinary commercial transactions. It is impossible in many instances for businesses to conduct transactions with plans having such delays. In some instances the costs involved in obtaining an exemption are also prohibitive and in all instances they are too high.

Absent a massive influx of resources to the Office of Fiduciary Standards, the office with OPWBP which processes prohibited transaction exemptions, the exemption process will not work because there are too many plans needing relief and too few people to process those exemptions.

Accordingly, I think the only meaningful relief can be obtained from a change in the statute itself. One idea, would be to go to what is known as an "arms-length", "adequate consideration" standard coupled with a shift in burden of proof to the party that engages in the prohibited transaction. This type of standard would mean that if a transaction which otherwise violated section 406 were in fact at arms-length and that full consideration was given to the plan for the transaction, then it would not be a violation of the act. However, to make such a standard more enforceable, the party claiming the benefit of this exemption would have the burden of proof to show to the Department if the transaction were challenged, that the transaction was at arms-length and prudent. If the party in interest did not meet his burden then the prohibited transaction penalty would apply.

The Department of Labor has always contended that an arms-length standard is unenforceable, particularly because it would require a great burden in litigation to show that a transaction was not for consideration. Hopefully a change in the burden of proof, perhaps with some other additional changes, might give the Department of Labor sufficient protection that the prohibited transaction provision could still be enforceable and provide the needed protection while allowing beneficial transactions to occur.

My suggestions are not a criticism of the Office of Fiduciary Standards. I think they have done admirably well, and given the resources, have done a remarkable job of processing those exemptions which have been submitted to them. However, the universe needing prohibited transaction relief is so large, that the small staff at the Department of Labor could not hope to meet the need. The only reasons that the process has not bogged down completely is that (i) the Office of Fiduciary Standards has done a great job with minimum resources, and (ii) the prohibited transaction rules are ignored in many instances by the employee benefits community.

VIII. DUTIES OF FIDUCIRIES UNDER ERISA IN EXERCISING THE VOTING RIGHTS OF STOCK HELD IN PENSION FUND ACCOUNTS.

The positions taken by the Department of Labor to date are certainly correct and mandated by the statute in relationship to the duty of fiduciaries with respect to exercising voting rights of stock held in pension fund accounts. A fiduciary cannot escape his obligations under 404 of ERISA. A fiduciary has the duty to inform himself of the affairs of the corporation in connection with those corporate matters which might affect the value or the rights which a plan has as a shareholder. The fiduciary then must make a prudent evaluation of those issues and vote the stock accordingly.

For too long, there has been too cozy of a relationship between some institutional fiduciaries and the companies whose stock those institutional fiduciaries are voting. In the past, it appears that institutional fiduciaries routinely voted with management regardless of the nature of the proposals. In today's world of green mail, poison pills, golden parachutes and all kinds of creative devices to protect intrenched management, plan fiduciaries have an even greater obligation, particularly when they own large blocks of corporate stock, to keep themselves informed as to corporate governance issues and other issues which affect the value of the plan's investment and to vote accordingly.

It is difficult for the Department of Labor to enforce these fiduciary obligations unless the abuse is brought to their attention. The Department has no way of knowing how a particular fiduciary is going to vote on an issue. Unless given notice through publicity or a complaint of a participant or someone involved in the decision, the Department has no way of knowing of the abuse. Further, time frames are often fairly short and it is difficult for the Department to do a sufficient in-depth investigation to be able to respond within the time constraints which it often must meet. The situation is further complicated for the Department because the parties in the typical corporate fight are well financed. For the Department to take them on means a major commitment of scarce resources. I would think that the Department would not want to get involved unless the abuses were quite clear and clearly detrimental to the interest of plan participants and beneficiaries.

IX. CORPORATE TAKEOVER SITUATIONS.

The Department of Labor articulated its position very well in the corporate takeover area. In short, when fiduciaries are involved in a corporate takeover situation, the decision to tender shares or to acquire shares must be made solely in the interest of plan participants and beneficiaries. Where management trustees are in control of the plan which is involved in the takeover fight, an irreconcilable conflict of interest exists. Management trustees should either resign and allow independent trustees to make the decisions or should obtain independent objective advice and act upon that advice.

Corporate fiduciaries cannot blindly hide behind plan provisions which direct that stock may not be tendered or that it only be tendered under certain circumstances, such provisions designed to make tendering more difficult. Although plan fiduciaries must follow plan language, this obligation exists only so long as the language is consistent with ERISA. Provisions which are designed to prevent the tendering of stock and place restrictions upon such tender, under many fact circumstances may be violative of the of the law and cannot be followed.

Nor in most instances can plan fiduciaries pass on the decision to plan participants as to whether or not to tender the stock. I am unaware of any provision in ERISA which allows such a decision to be passed on to plan participants, except in the case of an individually directed account. Certainly, a fiduciary may take into consideration as one of the many factors how plan participants or beneficiaries vote on an issue, but such fiduciary still has an independent duty to exercise its responsibilities with respect to the tender offer.

In circumstances where the information which has been passed on to shareholder participants is incomplete, or the mechanism for voting does not give plan participants adequate opportunity to express themselves, or the nature of the information or the circumstances surrounding the conveyance of the information would lead to coercion or misinformation; any vote of plan participants should have little weight in a fiduciary's decision to tender or not to tender.

Retirement funds were not intended to be tools of intrenched management to protect itself or to allow management to further corporate interests. Although ERISA recognizes that fiduciaries may have two hats, that of corporate manager and trustee, when acting in their fiduciary capacity, such managers must act in full compliance with their fiduciary duties under ERISA.

Corporate takeover situations highlight some of the limited enforcement capabilities of the Department of Labor. As in other corporate governance issues, the parties may be well financed. To take them on requires a major commitment of resources from the Department. Almost always time constraints are very short, which leave the Department little time to analyze the issues and take appropriate steps before the harm is done.

Even with these problems, where the Department has chosen to intervene, they have been very effective and certainly ought to be commended for such efforts. Secretary Donovan at one time suggested in an interview with the Wall Street Journal, that the Department was going to create "response teams" which would have particular expertise in the corporate takeover area. These teams could be called upon to investigate and develop information so as to enable the Department to act quickly and decisively in those situations where abuse appeared to be present. Such a concept is one which merits consideration. Perhaps some sophisticated training from the field through the national office and in the SOL in corporate governance and takeover issues might well enable the Department of Labor to respond in a more effective and timely fashion where abuses are likely.

The Department has done an excellent job in establishing fiduciary concepts arising from corporate governance and takeover situations. Given resource restraints, I doubt they could have been expected to do a lot more than they have done.

PREPARED STATEMENT OF IAN D. LANOFF

Mr. Chairman and Members of the Subcommittee:

Thank you for inviting me to testify as former Administrator of the Office of Pension and Welfare Benefit Programs (OPWBP) of the United States Department of Labor (DOL or Labor) with respect to the implementation of the Employee Retirement Income Security Act of 1974 (ERISA or Act). You have requested that I testify with regard to my views relating particularly to the enforcement of ERISA and the administration of the Act's fiduciary provisions.

I was appointed Administrator May 23, 1977 and resigned effective December 12, 1981. I am as committed to the effective enforcement of the provisions contained in Title I of ERISA today as I was when I served in the Labor Department. I concur with the language contained in the Preamble to ERISA which states that ERISA was passed first and foremost to protect "the interests of participants in [private] employee benefit plans and their beneficiaries." It concerns me very much that the promise of ERISA remains unfulfilled due to the absence of a credible and consistent enforcement program.

During my tenure the Administrator reported to the Assistant Secretary of Labor-Management Services Administration (LMSA). The Administrator had no direct authority over the field staff which was directly responsible to the Assistant Secretary of LMSA. In 1979 OPWBP in DOL and the office of Employee

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* My gratitude to Susan L. Gurny, J.D., Columbus School of Law at Catholic University for assisting me in preparing this testimony.

Plans and Exempt Organizations (EP/EO) in the Internal Revenue Service (IRS) implemented Reorganization Plan No. 4 as passed by Congress which provided for the splitting of the administration of ERISA. Authority for the administration of the participation, vesting and funding provisions was shifted entirely to the U.S. Department of Treasury and authority over fiduciary provisions including applications for prohibited transaction exemptions was granted to DOL. Each agency retained responsibility for enforcement which was primarily carried out through the respective field offices.

Today, the Administrator reports directly to the Secretary of Labor and has direct authority over field staff. Both DOL and the IRS continue to administer the Act pursuant to Reorganization Plan No. 4. I am of the opinion that for a variety of reasons which I will explain in greater detail below, ERISA has never been enforced as its drafters expected and that the best way to achieve that expectation is through the establishment of a single agency.

When ERISA was passed about 35 million people were covered by about 1.8 million private employee benefit plans in the United States. The initial emphasis in administering ERISA was placed on educating all the parties involved. Pension attorneys, accountants, actuaries and service providers needed to learn the new requirements imposed by the law. Plan administrators needed to learn how to comply with the law and plan participants and beneficiaries needed to be told the safeguards afforded them by the new law.

In the meantime, due to the complexity of the law, and the requirements imposed by the law in an incredibly short period of time, delays developed in issuing rules and regulations and administrative exemptions from the prohibited transaction provisions. Further, the reporting requirements were burdensome and created excessive paperwork.

This was the environment in the pension community when I became Administrator. Time, the individual initiative of the agencies and Reorganization Plan No. 4 eventually alleviated the initial problems in implementing ERISA. For example, the IRS, DOL and the Pension Benefit Guaranty Corporation (PBGC) reached an agreement on the single filing of the 5500 Annual Report Form series. Reorganization Plan No. 4 reduced the initial delays in issuing regulations and the processing of applications for exemptions from the prohibited transaction provisions of ERISA. The passage of time gave the agencies a chance to learn to administer the provisions of the Act. The priority then became the effective enforcement of ERISA. While authority over the vesting, participation, funding and fiduciary provisions was divided between the agencies under Reorganization Plan No. 4, the Reorganization Plan did not affect enforcement provisions which had to continue to be coordinated among the agencies. Unfortunately, this has not worked well.

The problems within the Labor Department are primarily attributed to lack of resources and internal management problems. Due to the lack of resources, there is insufficient personnel to maintain an effective enforcement effort. The personnel are untrained and there is a lack of information to target enforcement efforts.

Currently, there are 43,200 pension plans with more than 100 participants, 732,000 pension funds with more than 100 participants, 63,900 welfare plans with more than 100 participants, and an estimated four million welfare plans with fewer than 100 participants. It is estimated by the OPWBP staff that to conduct a random audit of a two percent sample of the smaller plans every year with the goal of attaining the highest level of voluntary compliance, and a review of each of the larger plans, 2,600 investigators would be necessary. In fact, there are 175 investigators and auditors policing this plan universe. (The budgeted ceiling is 223.) This is a direct result of Congress not allocating adequate funds to permit DOL or the IRS to examine plans at a rate similar to other financial enforcement programs like the Securities and Exchange Commission or the Federal banking regulatory agencies. In addition, since 1980 all government agencies have experienced personnel cutbacks and the agencies administering ERISA are no exception.

ERISA is one of the most complex and comprehensive statutes ever enacted into law. Upon its passage, investigators were transferred from LMSA without any training in employee benefits. Since that time only four training programs have been held in ten years and even though the quality of investigators has been upgraded, in many cases their qualifications fall short of the requirements of the job.

Lack of information about pension plans to be investigated poses a myriad of problems. Because of initial criticisms about the excessive paperwork caused by ERISA, DOL and IRS agreed to share the information gathered on the Annual Report Form 5500. The IRS receives that information and is responsible for coding it and forwarding it to the Labor Department. This process does not work well for purposes of fiduciary enforcement for several reasons. First, the information received by DOL investigators is incomplete for their purposes. IRS only codes fifteen items on the Form, including identifying information. Discrepancies in plan operations cannot be detected with the small amount of information given. Second, delays in receiving information mean that Labor investigators often do not have the most recent Forms filed. Assuming that all information is received in a timely manner and is complete, it takes at least a year for Labor to receive the information. Thus, investigators often must ask the plan to supply the most recent copies of their Annual Report, severely hampering their credibility as capable enforcers.

The second major source of the problems at the Labor Department in enforcing ERISA is its internal bureaucracy. In the first place, there are the internal bureaucratic pressures exerted upon both OPWBP at DOL and EP/EO at the IRS. The purposes of the IRS and DOL, in general, are different from the goals established by ERISA which OPWBP and EP/EO seek to implement.

The Departments of Labor and Treasury have buried the offices administering ERISA down on the hierarchical ladder. Couched within larger bureaucracies, OPWBP and EP/EO compete with other offices for scarce resources and the ear of the Secretary of their Department. The Administrator of OPWBP and the Assistant Commissioner of EP/EO are far removed from the President of the United States, and all communications to the higher levels of the government must filter through many layers of bureaucracy. While the Administator now reports directly to the Secretary of Labor, recently EP/EO has been moved further from the sources of power within the Treasury Department by the imposition of an additional layer of bureaucracy between the Commissioner of the IRS and the Assistant Commissioner of EP/EO.

Frequent changes in the position of Administrator of OPWBP and the ongoing rivalries between different factions of the Labor Department have resulted in an inconsistent philosphy of enforcement, in the lack of independence of the enforcement branch, and the perception that no climate for enforcement exists within the Department. Seven people have occupied the position of Administrator since its inception in 1975. As a result, the enforcement program has been subject to frequent changes and reversals. Inititally, emphasis was on voluntary compliance. Criticism of enforcement emphasizing technical assistance and public education led to the inauguration of the significant case approach in 1978 after I became Administrator. Acknowledging the scarcity of enforcement resources, this approach sought to bring the greatest good with the available personnel by focusing on fiduciary investigations of large plans. It took several years before the system worked well. Field investigators had to be taught what constituted a significant case and the Solicitor's Office within the Department of Labor and the field offices throughout the country had to develop a working relationship.

The significant case approach purposely gave a lower priority to many areas of ERISA enforcement, including delinquent and deficient annual report filings, criminal investigations and small plans. The Government Accounting Office, a report written by a Senate staffer (the Walsh report), and the Senate Labor Committee criticized the Department's enforcement program for the above deficiencies. In response to these criticisms, the Department redirected its enforcement efforts as soon as I departed in 1982. It dropped the significant case approach to emphasize criminal enforcement, greater review of small plans, and consideration of nonfiduciary violations. This newest enforcement effort is being criticized for its lack of defined strategy, its vagueness, and its inconsistency. Given the current vacancy in the position of Administrator of OPWBP, enforcement policy has not yet been redirected in response to the latest comments. In my view, the significant case approach to ERISA enforcement worked extremely well and the next Administrator should be encouraged to have it restored.

The enforcement division of OPWBP has suffered from the lack of independence that OPWBP itself has endured. In essence, the Department grafted ERISA enforcement onto the pre-existing structure of LMSA. Enforcement therefore became decentralized.

ERISA investigators have not yet been given a great deal of autonomy. Perhaps because of the ongoing scrutiny of their actions, the Department has kept a very close eye on their progress. In response, investigators have been very conservative instead of engaging in prudent risk-taking which might enhance their enforcement efforts.

The ERISA Enforcement Working Group noted that a climate for enforcement did not exist within the Department. Although they could not single out an overriding factor, they noted a lack of zeal within the Department for enforcement, the delegation of criminal investigations to the Department of Justice, and the lack of consideration for the impact administrative decisions would have on program enforcement. The lack of continuity of enforcement policies and the high degree of outside criticism create an unstable enforcement environment.

The record shows that the Department of Labor has been unable to enforce ERISA in a consistent manner. Its resources never have been sufficient to mount a credible, across the board enforcement effort. Shifting priorities in the management of those assets has weakened enforcement still further. Despite recent reorganizations of OPWBP which should give the ERISA program more autonomy, there is little reason to hope that ERISA enforcement will improve dramatically in the immediate future unless the resources necessary for adequate staffing and training are allocated to OPWBP. Also, the ERISA program, once again, is without a leader.

ERISA required the agencies involved in administering the law to coordinate their enforcement efforts and Reorganization Plan No. 4 left this structure untouched. Not only are there the DOL problems but there is also the lack of coordination with the IRS over the emphasis to be placed on the enforcement of ERISA as well as how ERISA should be enforced. It is the responsbility of the IRS to qualify pension plans and even though the IRS has the means to enforce ERISA vigorously it has placed a low priority on ERISA enforcement and instead considers its main function to be revenue raising.

To date, IRS has not developed a compliance tracking system to help select plans for audit. Although it conducted 27,732 examinations of employee plans in 1984 compared to 12,461 in 1978, this constitutes less than three percent of all plans, a meager sampling at best.

The IRS has been dilatory in other aspects of its ERISA enforcement program. It has the responsibility for processing the 5500 Form, but no records exist of the IRS assessing any penalty for failure to file an Annual Report or filing an Annual Report with deficient information. The IRS has also apparently abandoned its widely publicized program to compare tax deductions taken for contributions to employee benefit plans with filings of 5500 Forms.

In general, coordination does not work well because of differing perspectives over what constitutes a violation and placing different priorities on different aspects of enforcement. Agencies do not seem to follow up on leads given to them by other agencies, nor do they actively check the status of matters referred to other agencies.

The IRS places a low priority on enforcing the ERISA responsibilities Reorganization Plan No. 4 delegated to it. It places an even lower priority on cooperating with other agencies to coordinate enforcement activities. The 5500 Forms already discussed, the case referrals for excise taxes, and the checklist procedures, explained below, illustrate the difficulties.

In 1978, Labor and Treasury officials were disappointed when key members of the Congressional tax committees balked at transferring fiduciary enforcement authority to Labor as part of Reorganization Plan No. 4. In 1979, to make up for this Congressional roadblock, Labor and the IRS instituted an arrangement whereunder agency investigators were to swap checklists containing the results of their investigations. The aim of their program was to avoid duplicative efforts, thereby preserving agency resources and avoiding undue interference in plan sponsored activities. It is my understanding that despite Labor's best efforts the IRS never fulfilled its obligation pursuant to this program.

In 1983, DOL and IRS agreed that DOL would transmit cases to IRS which it felt were violating provisions of ERISA and were thereby candidates for the imposition of an excise tax. Of 390 cases which were referred between June 1983 and May 1984, 123 have been closed. Of those 123 cases, 107 were closed with no action by the IRS and 16 cases resulted in the imposition of an excise tax. Labor concludes: "Based on these results, DOL's agreement with the IRS does not appear to be working as planned."

Coordination also has not worked in the establishment of a data base for ERISA enforcement. The IRS may code 5500 data according to its own needs, but fails to provide Labor with adequate information. It is hard to see how this problem will be solved when data funds come out of separate budgets.

Based on evidence, one can conclude that the Labor Department cannot enforce ERISA alone; the IRS does not choose to enforce ERISA; and coordinated enforcement does not work.

When I became Administrator there were $212 billion of assets held by private pension and welfare plans. Today, there are one trillion dollars of pension reserves and $60 billion in tax expenditures each year for pension contribution deductions.

Pensions clearly are linked to the budget deficit and tax policy. In addition, retirement income security is an extremely important constituent issue. Instead of backing off from the issue because of its complexity, policymakers on Capitol Hill and in the Executive Branch of the federal government must make every effort to understand the issues and make decisions to ensure the income security of future retirees.

The current administrative apparatus of ERISA needs to be changed. The framers of ERISA recognized its inadequacies when they sacrificed good management for passage of the law. Time has shown that the current administration does not work well. Pension beneficiaries and participants are being short-changed. However, the problems persist. Nothing solves the problems I have identified or holds out the promise of solution like an independent agency for ERISA administration. With a single agency, there will no longer be two agencies with overlapping enforcement responsibilities pursuing different priorities. Information useful for enforcement purposes will be immediately available to agency investigators. An independent agency will be more likely to gain adequate resources, particularly in the personnel area. And perhaps more importantly, a single agency stands a better chance of developing the continuity in personnel which will underpin a credible and consistent fiduciary enforcement program.

I would be happy to answer any questions you may have.

Senator COHEN. Mr. Gordon, it's a pleasure to welcome you. You've had a long involvement with pension issues.

During the 1960's, Mr. Gordon was the counsel for President Kennedy's Cabinet Committee on Corporate Pension Funds. From 1970 to 1975 he served as Senator Javits' counsel on the Senate Labor Committee that drafted ERISA. Since then he has practiced law in Washington specializing, oddly enough, in ERISA matters.

Mr. Gordon?

TESTIMONY OF MICHAEL S. GORDON, ESQ.

Mr. GORDON. Thank you, Mr. Chairman.

I have a long statement and I intend to summarize it.

Senator COHEN. It will be included, Mr. Gordon, in the record in full.

Mr. GORDON. Thank you.

First of all, let me say, I much admire your courage and that of your staff to proceed to examine these problems. Your ability to withstand what may be great pain is I'm sure something we all admire. And also I have to say that there really isn't very much for me to clean up on even though I'm batting fourth.

There is a lot that was said that it would be perhaps useful for me to try to comment on but I do think that I can't reach all of the issues that have been raised without taking an inordinate amount of time. So what I'm going to try to do is just briefly hit the highlights of my statement, and at the same time try to talk to some of the points that were brought up.

First of all, I think that we have to understand that the administration of ERISA has to be viewed in historical context. It's something that took place as the result of a huge outcry against the wide range of abuses that were occurring and there really wasn't much serious regulation of private pension and welfare benefit funds prior to ERISA. So there were specific complaints and specific concerns that Congress intended to address itself to, and obviously, in many respects, they did not, and probably could not have, anticipated many of the regulatory problems that flow from only trying to attack on particular points.

The main thing Congress tried to do was to adopt the minimum regulatory approach, recognizing that we have a voluntary system here, that it's necessary to have some type of standards, uniform Federal standards, to safeguard participants against abuse, but not to try and go so far as to lay all kinds of restrictions and regulations on plans that might discourage their voluntary character.

Now, what the proper balance should be constantly shifts. There was nothing in ERISA when it was enacted that assured that somehow the controversies that raged at that time over the appropriate balance were suddenly going to stop because the law was enacted. In fact, they didn't stop.

And what happened was that right after ERISA was enacted, there were rather strenuous efforts on behalf of those who had been previously unregulated to attempt to try to get the standards that were in the law watered down or adapted to meet their particular needs as they saw them.

I think it's easy to criticize what the Department of Labor has been doing over the past 10 years or more in administering ERISA. But we have to understand that they were immediately confronted with all of the prominent segments of the private pension industry that were being regulated, running in to try to get the statute adjusted to their particular concerns and needs.

And I think that while there have been some areas of inefficiency, and some areas where the department has clearly taken a wrong turn, at least in my view, and some areas where they've even ignored problems that, by and large, they've done a pretty good job in implementing the statute and getting everybody to understand just exactly how significant these pension issues are, Obviously they can do a lot more if given better resources. It's perhaps, in some ways, amazing that they've done as well as they have in many respects.

Each of the three administrators whom we've heard from—in fact, all of them—really deserve great credit for having achieved the stabilizing of ERISA. That was an important achievement and should not be underestimated.

However, it's my view that what's happened is that while the Department of Labor has spent a great deal of effort trying to stabilize ERISA, to make it livable and workable for those who are subject to its regulatory burdens, they have not been as quick or as alert to adjust and take account of new threats to the integrity of private pension funds. I think right now the most important threat which, in my view they have really failed to develop a unified coherent strategy for dealing with, is this new tendency of many corporations—not of all, but of many corporations—to try to manipulate, in one form or another pension plan assets to serve the immediate financial and/or corporate objectives, and at serious risk to the interests of participants and beneficiaries. A lot of this is perhaps due to the recent economic climate but a lot of it, I think, is due to the fact that an aggressive effort has been made to try to exploit the weaknesses and loopholes in ERISA, and there are those weaknesses and loopholes as there are in any statute, particularly one that was passed over 10 years ago.

Senator **Cohen**. Can money managers resist the kind of pressure we were discussing this morning, in that we have investment firms or insurance companies who have interlocking interests or portfolios in a number of companies and they have tremendous financial pressure being placed upon them? Aren't they under an extraordinary amount of pressure to go with the management on the antitakeover measures?

Mr. **Gordon**. I think that the pressure has always been there. The real issue is whether or not ERISA requires them to behave in a manner which compels them to act independently of those pressures in the interests of the participants and beneficiaries.

I believe it does. I heard reference earlier this morning, to what Bob Monks referred to as the Chinese Wall. I've never seen a Chinese Wall in a bank; I'm still waiting to see one. But I've heard it exists. But there are examples where the banks have, shall we say, on occasion, and certainly prior to ERISA, strayed over the Chinese Wall and made investments on behalf of their trust departments that were designed to support their commercial transactions.

Those were attacked in a kind of haphazard manner prior to ERISA. But ERISA certainly makes it clear to any trustee, bank or otherwise, that it can not do such things. I don't see any difference between that principle and voting the stock of a particular corporation.

If, in regard to a particular investment, a fiduciary automatically falls into the pattern of favoring management, and it does not take an independent view in terms of voting stock on behalf of the trust department, then they're in violation of the law. And the Labor Department ought to act on it.

Senator COHEN. What about the Wall Street rule?

Mr. GORDON. I think, there, in general, I believe.

Senator COHEN. Couldn't a fiduciary say, I believe in the Wall Street rule. If I don't like the management, I just sell that company's stock and buy another stock. Isn't that prudent?

Mr. GORDON. It may or may not be. But that's a little different issue than the one that was presented before. The one before sounds more like conflict of interest. That is a problem which can be handled under ERISA by the Department of Labor.

But, in terms of what is prudent for the fiduciary to do, that's a different issue. And there, we have obviously a controversy. My own opinion as expressed in the testimony is that by and large fiduciaries don't have to explore the various nuances of corporate takeover fights. All they have to do on behalf of a plan is find out what it means in terms of the investments that are carried on behalf of the plan.

However, it seems to me there are situations where, there could be a takeover proposition that is clearly of the type that would end up destroying the target as a viable business entity and also, if these takeover tactics are successful in general they might tend to limit the universe of long-term, sound investments for pension funds.

So, in that regard, maybe the trustees have some responsibility to be a little bit more active in trying to defeat those kinds of efforts, and perhaps side with management.

Senator COHEN. Do we have to amend the ERISA law—I think you indicate this in your testimony—to try to insulate the plan during a takeover?

Mr. GORDON. Yes. I think what we have now, and it was referred to briefly by earlier witnesses, that the Department of Labor tried to bring the deal with this in the *Grumman* case, and they lost on it, which is too bad; they lost on the point that there was an automatic conflict of interest, and that it amounted to a prohibited transaction for the trustees of a pension plan, who were also officers of a corporation who had an interest in avoiding the takeover to trying to secure Grumman stock by the use of plan assets that they could entrench themselves.

As a result of having lost that point, what it means is that the Labor Department now always has to litigate the question or threaten litigation on the question of whether the corporate officers who are also the trustees are really acting in the interest of the participants and beneficiaries.

It seems to me we shouldn't have to wait around to find out in each particular case whether they've done it right. The conflict is so clear because their jobs as corporate officials are at stake, that what we need to do is throw up a kind of a cordon sanitaire around plans at this stage and say that those decisions can't be made by such officials. We're going to take them out of their hands. They're different than the ordinary kind of investment decisions where officials who are also trustees invest plan assets in securities of the plan sponsor, because, there, their jobs aren't at stake. Therefore, it's not a real personal conflict of interest.

Senator COHEN. Do you throw up this cordon once the tender offer is made?

Mr. GORDON. I haven't really thought it through that far. Certainly, at least at that point, it seems to me it ought to be thrown up. The problem is that many of these folks are anticipating takeovers, or they have overfunded pension funds, and we can't ignore that part of it as well; because whatever it is that they do with regard to ongoing pension funds, if they can get around it by terminating the pension fund and taking the same assets by way of surplus in activities that are forbidden to them if the plan was still alive, then it seems to me there's another loophole that has to be closed.

And, certainly, I would say, at the point the tender offer is made, these decisions ought to be taken out of their hands. It ought to be placed either in the hands of an independent, strictly independent, fiduciary or submitted to the Labor Department under the prohibited transactions exemption procedure.

Senator COHEN. What do you mean by "nipping the problem in the bud" in your testimony? You say that in these corporate takeover situations, the Labor Department has not been aggressive enough and it should be nipping the problem in the bud rather than waiting for litigation?

Mr. GORDON. That's right. Actually, it refers back to what I just said. In some of these situations, they can see what's going to happen but all they can do is wait until an actual tender offer is made before get the information. Then, assuming they can act in time, they may bring the parties in and threaten litigation and maybe they'll be able to get some results.

But, if it was clear at the outset that regardless of whether an actual tender was made, that if management felt threatened, and that was the basis for using plan assets to make the investment or to place restrictions on the voting of plan sponsor's stock held by the plan, that the Department could automatically void the transaction, I think that would have an effect, because that's what they're really concerned about.

No matter how you slice it, whether they're using pension fund assets to try to defend themselves against a takeover or to try to assist in the takeover, basically what they're doing is they're subordinating pension fund assets to management objectives. That's the abuse. And that should be simply cut off right now. You shouldn't have to wait and have to litigate each case.

Senator COHEN. What about small companies? Would they have a problem as far as being forced to find an independent trustee?

Mr. GORDON. It might be. But, you know, common law has dealt with these kinds of problems. And maybe it would be just as well if some type of independent attorney could be designated to make these decisions on their behalf. I'm not sure you always have to go out and hire a professional trustee to solve the problem.

Senator COHEN. You were critical in your prepared statement about asset reversion schemes that are now being invoked. What would you do to correct that? Would you change the law?

Mr. GORDON. Yes. I think there's a bill pending right now that's been introduced in Congress by Congressman Roybal. I don't recall the exact number of it. But what it would do is limit the circumstances under which plan sponsors could recover back excess plan assets. It would not prevent them from terminating the plan, but it would say that if you haven't terminated it for a legitimate business purpose, then you cannot recover these plan assets and it would not be a legitimate business purpose to simply terminate the plan so you can protect yourself against a takeover. That's not allowed. In effect, the discouraging mechanism would be, under those circumstances, that you would have to distribute such surpluses to the participants.

Senator COHEN. You indicate in your testimony that about 500 corporate pension plans since 1980 have been or are waiting to be terminated, and that $6.2 billion set aside under the plans for workers have now been recaptured by the plan sponsors.

In your judgment, were any of these terminations appropriate?

Mr. GORDON. Some of them might have been because they might have been brought about by legitimate business stress, but it appears from my analysis, and the analyses of others, that the overwhelming majority of them were not in that category. And many of them, a significant number of them, now and in the pipeline, have as their sole reason to prevent the corporation from being a takeover target, or to use the assets aggressively as a defensive measure in a real takeover scheme.

On either grounds, it seems to me——

Senator COHEN. Should terminations for such reasons be barred by statute?

Mr. GORDON. Well, the whole purpose of these pension plans is being flouted.

Senator COHEN. One of the issues we didn't really cover during the prior testimony deals with the allegation that because the exemption process for prohibited transactions is so long, there are many lost investment opportunities. Therefore, we've got to either have a statutory change and make it an arm's-length, adequate consideration rule, or we have to have broad-class exemptions or some other policy, perhaps an SRO or something else.

Do you agree that there have been investment opportunities lost and that therefore, we have to have a different policy?

Mr. GORDON. Well, I think probably in the abstract sense, that's true. Investment opportunties have been lost. I represent some small-plan clients and I agree with some of the statements that were made, that quite frequently there are situations in which what purports to be a good investment opportunity has to go by the wayside; generally, because they simply don't want to bring it to the attention of the Department of Labor and have it focused on, not because the process is so long and awkward.

However, we have to temper that by realizing that when we say "investment opportunities," these are investment opportunities that are being promoted by insiders to the plan. That's where the greatest dangers of abuse exist, and while they can tout them as being terrific investment opportunities, it should also be understood that their objectivity is somewhat suspect because they're the ones, or their company or union is going to be the one, that's going to benefit by it.

So I think the whole purpose of the prohibited transactions and the exemptions is to try and present some objectivity in the situation, and if it is such a terrfic investment opportunity, then it will be approved.

But if you take it for granted that simply because the insider decides that it's a terrific investment opportunity, that it ought to go ahead without any further regulatory controls, then I think we're asking for a lot of trouble. And that's exactly the kind of trouble that we had in spades prior to ERISA.

Senator COHEN. So you're saying, from a public policy point of view, that the judgment was made that even though some business opportunities may be lost, that for the overall good of the plans themselves, we ought to have this prohibited transaction exemption process in order to provide a period of time to counter that quick insider opportunity.

Mr. GORDON. That's right. I think time, to some extent, is helpful here. But, I don't condone unreasonable delays or foot dragging on behalf of any administrative agency. I think they're a waste. I think we ought to speed up the exemption procedure. And one of the ways I suggest in my testimony is perhaps to turn over the exemption request from the service providers, like banks, insurance companies, and those in the securities industry, to agencies who already regulate them.

Senator COHEN. One of the more distressing parts of Mr. Clayton's testimony that I didn't really have a chance to focus too much on was the notion that the marketplace is simply ignoring the prohibited transaction rules and is not worried terribly about being caught and penalized, fined, or whatever. Plans and parties in interest are ignoring the prohibited transaction rules, not filing for exemptions because it takes too long, and are simply going forward.

Have you found in your experience as an attorney in the field that there's a good deal of this going on?

Mr. GORDON. I think it varies a great deal. And I think where it is ignored, it's basically ignored in many instances out of ignorance and there has not been proper legal advice, or what-have-you, provided in advance.

But I would tend to disagree about its effect. I agree more with Mr. Lanoff. It does have a kind of *in terrorem* effect on not just those who are large plan sponsors, or their attorneys who are advising them on every single transaction, but it also has an effect on medium and small plans and their attorneys. It does work.

Senator COHEN. It could be done out of ignorance. If we are turning these decisions over to professional money managers and trust departments, and considering all the expertise that plans are paying so dearly for, how can it be done on the basis of ignorance?

Mr. GORDON. You would be appalled, I suppose, and maybe surprised to find out that there are many, many plans which only purport to turn over portfolio management to professionals. In fact, they don't. They only have custodial responsibilities, or they have limited investment responsibilities. In many cases, they have none whatsoever. In fact, currently, there is a trend toward returning investment management responsibilities in-house; to the extent that that trend is also followed by small plan sponsors, and, parenthetically many will grab onto these trends whether it's terminations or in-house conversions. It's sort of monkey-see, monkey-do, but they do it without gaining any real clear-cut reduction in costs, when they bring it back in-house. Moreover, they really don't have what it takes to make it work.

Senator COHEN. I have one final question for the time being, assuming you have more testimony you want to present.

Mr. GORDON. No. I prefer that you ask and I'll answer.

Senator COHEN. I have a question as to the plan sponsors. What about Mr. Monks 'suggestion that because the marketplace has become so webbed with conflicting interests and so many overlapping directorates and investment opportunities, and so forth, that the professional money managers no longer can exercise their voting responsibility free from conflicts of interest? And, should this responsiblity be exercised by the plan sponsor.

Mr. GORDON. He certainly has raised a very profound problem, and it's been one that has been looked at off and on over the years a great deal. And there's never been any real resolution of it.

I can recall back, I think it was in the early seventies, that Congressman Wright Patman looked into the concentration of investment powers among bank fiduciaries and came forth, for him, with the not too surprising conclusion that these concentrations of powers and conflicts of interest were serious, and the impact on the economy and on pension funds was something that had to be really studied and worried about.

But let me point out, Mr. Chairman, that if you take these responsibilities and shift them over to plan sponsors, you're making them fiduciaries. One of the reasons why we have this delegation of responsibility to the professionals that was referred to earlier, and why it permits plan sponsors to get off the hook, is to encourage them to establish these plans. If they're going to have to be responsible not only for establishing and designing and funding these plans, but also to be acting as fiduciaries in these very, very delicate situations, many of them will choose not to establish these programs at all.

So this was a method that was deliberately designed to try to professionalize, to the largest extent possible, the carrying out of fiduciary responsibilities, without inhibiting plan sponsors, who are basically amateurs, from establishing these programs.

I think we can deal with the problems that Mr. Monks talks about—conflicts of interest, and so on—by pursuing aggressively the principles that have been established about freeing up those who have these conflicts of interest and insisting that where they have them that they give over their decisions to independent fiduciaries.

Senator COHEN. Let us return to the prohibited transaction exemption process. Right now it's still taking 3 to 6 months to get an exemption; is that too long a period in your judgment?

Mr. **Gordon**. Well, it depends on the resources that are available. I've waited sometimes 3 or 4 years for one simple motion to get tried in the courts. This goes on and on and it's very hard not to be frustrated by these things, but I think it's more of a managerial problem than a problem that springs from the structure of the statute.

Senator **Cohen**. This is a bit different I suppose than trying to take advantage of business opportunities for the benefit of the plan. Perhaps lawyers are accustomed to waiting because of court dockets but one would expect that if you're dealing in the real world and you have an investment opportunity, you'd only have a limited period of time to take advantage of it. But not ad infinitum.

Mr. **Gordon**. I think that the exemption procedure is a troublesome procedure. I think that there can be ways found to relieve some of the burdens that have been placed on the Department of Labor in that regard.

As I've indicated before, I think a principal method that might be used is to take the Department of Labor out of the business of deciding what amounts to the regulatory responsibilities of other agencies. When it deals with request for exemptions for service providers in the securities field and the banking field and the insurance field, 9 times out of 10 it's really forcing itself to be educated and to deal with regulatory problems that exist sui generis, not just with regard to pension funds.

I see no reason why some of this burden cannot be taken over by some of the other agencies and in fact there's a provision in ERISA, section 506, that permits these types of cooperative arrangements with other Federal and State regulatory agencies.

If that were done, as I see it, that would leave the Labor Department to deal exclusively with exemptions from plan sponsors as plan sponsors, and that might hasten the response time considerably, and it might relieve the burdens because the Department of Labor tends to be more familiar with the conflict-of-interest situations as far as plan sponsors are concerned. Then, they wouldn't have to deal with all these ancillary regulatory problems.

Senator **Cohen**. What about Mr. Clayton's recommendation that you expand the granting of class exemptions as a way of speeding up the process.

Mr. **Gordon**. I can't tell whether he's disillusioned about it or not. Class exemptions were intended from the outset by ERISA. Specifically, there's language to that effect in the law; there's legislative history that indicates that Congress wanted the Department of Labor to act as much as possible through the issuance of class exemptions. And I'm somewhat puzzled, outside of the resource problems, why the Department of Labor can't deal with some of these problems more effectively through class exemptions.

Senator **Cohen**. What about the recommendations this morning about creating a single agency? As I understand, you went through wars for the creation of ERISA with all the conflicting committee jurisdictions but what about the merits, at least conceptually, of a single agency with nondivided powers and authorities.

Mr. **Gordon**. I think that the conceptual justification for a single agency is unassailable. I think it always has been. The sole reason that it's floundered has been because of jurisdictional and political, constituent-oriented considerations.

Regretfully, I can't offer any more optimism now than I offered Senator Javits 10 years ago about the legislative ability to obtain a single agency. But I think conceptually it's the way to go.

We have to remember that even though the purpose of the statute is to protect participants and beneficiaries of pension plans, there's no reason in the world why that cannot be successfully carried out by some agency other than the Department of Labor, and certainly no reason in the world why it can't be carried out by an agency other than the IRS or the PBG.

There are other aspects of pension regulation that you wouldn't believe that are hanging out there that have nothing to do with ERISA that are being administered by other agencies that might also be usefully consolidated in a central place. That would have a dramatic effect not only of easing regulatory burdens and also detecting and enforcing violations, but it would also elevate the entire subject to the prominent place in Government that it ought to really have.

Senator COHEN. One final point, the ERISA enforcement task force recommended to the Secretary of Labor that the pension office should obtain the assistance of public accountants to affirmatively disclose to the Department the activities by a plan. In other words, it puts them in a business of notifying the Labor Department of certain things they discovered during the process of analyzing the plan.

Mr. GORDON. You know, I thought that was something they were supposed to do anyway when they rendered their opinion and if their opinion is unqualified, it seems to me that what they're saying on the basis of their examination is that they have found nothing which suggests the possibility of abuse.

As I suggested in my testimony, having gone that far, it's unclear to me outside of the statistical justification that we would need a 5500 form at all.

Now, the problem is that accountants, independent accountants, when they render that opinion, do not actually go in and audit the books and records. So what they're doing is they're taking the books and records as they find them and what they're saying is on the basis of the books and records as they find them, there's nothing that indicates a problem. And if their opinion is construed, or if this public disclosure as you referred to it, is construed as requiring that, they provide that kind of disclosure by actually auditing the books and records of the plan, then we have somewhat of a major problem.

First of all, it's going to increase the costs and expenses of the pension plans very much. Second, it's always going to take a while to get that kind of thing done. However, I'm not sure in the last analysis that it is such a bad idea.

Senator COHEN. Thank you very much, Mr. Gordon.

I have some other questions for you. If you can answer them within a reasonable period of time for the record, it would be very helpful.

I appreciate your patience and again want to thank Susan Collins, Kim Corthell, and Mary Gerwin of my staff. They are the ones largely responsible for doing the research into an area which, I think you indicated, is full of complexity and challenges. I owe a good deal of credit to these three young ladies who have done all of the basic research.

Mr. **Gordon**. Thank you, Mr. Chairman. I hope you and your staff will persist in looking into these problems because this type of examination is sorely needed.

[Mr. Gordon's prepared statement follows:]

STATEMENT OF MICHAEL S. GORDON BEFORE THE SUBCOMMITTEE ON OVERSIGHT OF GOVERNMENT MANAGEMENT OF THE U.S. SENATE COMMITTEE ON GOVERNMENTAL AFFAIRS ON THE DEPARTMENT OF LABOR'S IMPLEMENTATION OF ITS RESPONSIBILITIES UNDER ERISA, ROOM 342, DIRKSEN SENATE OFFICE BUILDING, JUNE 25, 1985.

Mr. Chairman and Members of the Subcommittee. My name is Michael S. Gordon. I am an attorney practicing in Washington, D.C. who specializes in ERISA and employee benefits law. Prior to entering private practice, I spent well over ten years participating actively in the legislative process that culminated in the enactment in 1974 of ERISA. Specifically, during the 1960's, I served as counsel from the Department of Labor (DOL) to President Kennedy's Cabinet Committee on Corporate Pension Funds and other Private Retirement and Welfare Programs which, in 1965, issued a report that became the blueprint for ERISA. Then, from 1970-75, I served under an appointment by Senator Jacob K. Javits (R. N.Y.) as Minority Counsel for Pensions for the U.S. Senate Committee on Labor & Public Welfare, when the drafting of ERISA actually took place. Since entering private practice, I have represented both single, multi-employer and union pension plans, and, on occasion, plan sponsors, as well as participants and beneficiaries asserting a violation of their rights under ERISA. This diversity of representation has, among other things, provided the opportunity to test first hand many of the conceptual and practical dimensions of ERISA and to experience and observe DOL's administration of that statute. Needless to say, my views on that subject spring both from prior legislative background as well as current practice. I should add, however, that the views I present today are solely attributable to me and should not be regarded as necessarily representing those of any of my clients.

There is little doubt that ERISA was and is a monumental legislative achievement. Efforts to trivialize it or to highlight its deficiencies have not succeeded in disturbing the broad consensus that supported its enactment. While recognizing the need to avoid excessive restrictions that might jeopardize the voluntary nature of private plans, that consensus took as its guiding principle the view that minimum federal regulatory standards were essential to protect these plans against abuse and assure fairness in their design and operation. Without such federally mandated standards, public confidence in the private pension system could not be maintained, and without that confidence, the tax and other incentives that are the life's blood of the system could not continue to command public support.

This rationale for minimum federal regulatory standards now seems to be so apparent, so firmly established, that some may find it difficult to believe or understand that it took a fierce struggle lasting over ten years to achieve its legislative acceptance. What may seem even more peculiar to the uninitiated, is that the struggle did not cease when ERISA was enacted. To the contrary, it continued on, unabated, only its focus shifted from the legislative to the executive branch and to the agencies to whom the responsibility for administering ERISA had been delegated.

I submit that no proper assessment can be made of DOL's role in administering ERISA without taking these circumstances into account. It is easy to criticize DOL for taking the wrong turn on a specific policy issue or failing to resolve some long-standing administrative deficiency or behaving as if a serious problem does not exist when, in fact, it does -- and I intend to make a number of criticisms along these lines -- but the fact remains that DOL has succeeded in implementing its delegated responsibilities in a manner that has subdued, if not eliminated, the reaction of those plan sponsors and their allies who, from the outset, took a dim view of ERISA and constantly attempted to demonstrate that the new law was unworkable. Moreover, despite the varying politics of different administrations, without exception, each individual who has held the position of ERISA Administrator has advanced the cause of ERISA consistent with the statute's bipartisan origins. Upon examination, it will be seen that each of them made significant contributions, none of them attempted to turn the clock backwards, and all of them administered the law with moderation, tact and integrity. That is no small achievement and it has served not only to assure ERISA's stability but also its prospects for improvement.

However, despite this overall success and the continued durability of the ERISA consensus, DOL (and IRS and PBGC) have been relatively slow to grasp the significance of relatively new and ominous trends in the employee benefits field which now threaten to make much of ERISA irrelevant or obsolete. While these disturbing tendencies present themselves in a number of different forms, they seem to possess a unifying set of characteristics which can be briefly summarized as the willingness, even eagerness, of many corporate plan sponsors to sacrifice the interests of participants and beneficiaries to short-term management objectives and to openly doubt the continued desirability of major corporate responsibility for providing pensions, especially through the medium of a defined-benefit pension plan.

Some of this reaction is due to recent economic pressures which make it convenient for companies to rationalize a shift to ostensibly less costly methods of providing pensions by placing more of the financial responsibility on employees. In this regard, the ready availability and popularity of IRA's and Section 401(k) plans have helped to encourage plan sponsors to break away from long-established and previously successful patterns of providing pensions in order to accomplish cost-cutting objectives. In the absence of a national retirement policy which would seek to curb these tendencies, there is not much that DOL can do about them except to point out the likely ramifications for retirement income adequacy if these short-sighted actions persist.

On the other hand, where plan sponsors' maneuvers take the form of vigorously exploiting the chinks in ERISA's armor to the real disadvantage of participants and beneficiaries, then it is DOL's responsibility to aggressively defend the integrity of ERISA, and, if the legal weapons provided by that statute are found wanting, to seek more effective powers from the Congress. In this respect, DOL has failed, in my view, to develop a unified and coherent strategy which will clearly and unmistakably deter corporate plan sponsors from manipulating employee pension plans to their advantage. DOL has not acted at all to curb asset reversion schemes designed to entrench incumbent managements, it has done very little to halt the spread of "in-kind" employer contributions to pension funds, a number of which have consisted of virtually unmarketable securities of the plan sponsor, and it has promoted a method of attacking corporate takeover problems involving pension funds which still provides too much leeway to self-serving corporate insiders, and leaves too many questions to be resolved after litigation is brought rather than before, when many of these abuses can be nipped in the bud.

I believe that, with certain exceptions, civil procedures were intended to be, are now, and should be, the mainstay of DOL's enforcement efforts under ERISA. Breaches of trust were always fundamentally enforceable through civil means at common law even if certain aggravated forms of fiduciary violations could also be addressed under specific criminal statutes. I also believe that unless a flagrant violation is involved, the first priority should be given to achieving voluntary compliance as a means of avoiding unnecessary litigation. It is difficult to get competent fiduciaries to serve if their mistakes are instantly greeted by a lawsuit. The federal courts are overburdened as it is and ERISA cases tend to be complex and, more often than not, result in lengthy and costly proceedings which can and should be avoided whenever possible. In addition, I do not subscribe to the viewpoint that an agency's success in administering a statute as important and far-reaching as ERISA can be measured solely or even primarily by the number of cases it has brought and won.

Due to Congressional insistence, the emphasis has shifted slightly in recent years to give a greater prominence to uncovering criminal violations, but, with the possible exception of certain changes in voluntary compliance tactics, the civil enforcement strategy I have described appears to be more or less descriptive of DOL's overall approach and it is a sound one. However, its credibility is increasingly open to question when, on the one hand, DOL fails to act effectively to block what are widely perceived as run-away abuses by large, influential corporate plan sponsors, while, on the other hand, it does act in a more aggressive manner, and at the cost of expending substantial resources and investigative personnel, to uncover criminal violations in Taft-Hartley funds or the plans of small employers. In order to make the best use of limited resources and to safeguard the interests of the greatest number of participants and beneficiaries, the approach should be that, in the absence of direct, palpable evidence of criminal abuse or connections to organized crime, DOL should give its highest priority to securing civil compliance with the statute, and especially, to attacking on a sustained, coherent basis the growing problems of corporate manipulation of pension fund assets.

In this connection, it has been suggested that in order to achieve a higher degree of competence, productivity and efficiency in the design and implementation of ERISA investigations, DOL attorneys should be assigned an active participatory role in such investigations. There should, of course, be no objection to the hiring of attorneys or other professionals (e.g. accountants) as DOL investigators as a means of upgrading the quality of DOL's investigative staff. Many first-rate lawyers got their start in exactly that manner. Nor should there be any objection to the active participation of DOL attorneys in the training and evaluation of investigators or with respect to consultation regarding the appropriateness of specific investigative techniques. There are, however, serious questions about whether the independent professional judgment of DOL attorneys would be irreparably compromised in regard to making litigation determinations, if those attorneys or their colleagues have actively participated in the investigation that forms the basis for the recommended litigation. Whatever advantages there are to this approach as a means of improving ERISA enforcement, (and whatever success they may have had in certain limited situations), they are outweighed by the potentially profound risk to the balance and integrity of ERISA enforcement efforts, and it is a risk that is not worth taking.

It is, of course, difficult to perceive how to arrange enforcement priorities when it is unclear how important ERISA really is to an incumbent Secretary of Labor or Administration and what backing will really be provided if an ERISA Administrator embarks on a potentially controversial or innovative course of action. Over the years, unsuccessful attempts have been made to upgrade the Administrator's job to that of an Assistant Secretary as a means of assuring greater recognition of ERISA's importance and, in fact, the Senate version of ERISA would have created such a position but the idea was dropped in Conference at the behest of DOL.

Certainly establishing such a post would enhance the claims for giving ERISA problems a greater priority within DOL. Such an arrangement would also constitute a logical command post for the fashioning of broader retirement policies which are still sorely lacking. Given the enormous amount of funds at stake -- currently over $900 billion in assets, growing to over $3 trillion by the end of the century -- as well as the impact on the economy -- it makes sense to create a more systematic mechanism for advancing appropriate policies than the ad hoc approaches that are currently in the ascendancy.

But having one more Assistant Secretary is not a panacea. The fact is that most Secretaries of Labor are not terribly stimulated by the prospect of catching crooks and thieves who make off with pension funds -- not that it isn't important, mind you -- and most Administrations will lack the political motivation or inspiration to seek out more rational, more comprehensive, retirement policies. Regrettably, the last one that tried -- President Carter's Administration -- fell flat on its face. To round out the picture, pensions are horribly complex and pension law enforcement can easily make a well-intentioned Secretary of Labor despair of maintaining his popularity and credibility with either labor or management or both. Since ready access to top labor-management circles is an imperative of an effective Secretary, this means that pension issues will often be forced to take a back seat or will be avoided altogether.

The solution to this problem has been known for some time but, practically speaking, has been unattainable. Transfer administration of ERISA from DOL, from IRS, from PBGC and consolidate all of it and other aspects of pension regulation in an independent regulatory agency that looks like the SEC. Do that and ERISA and retirement policy issues will get all the attention they need and deserve.

I would like to turn now to some specific questions that the Subcommittee has raised concerning the following areas of ERISA implementation:

1. Reporting and Disclosure under Title I. Reporting and disclosure requirements under ERISA fall into two categories, reports and documents that need to be furnished to DOL, IRS and PBGC and those that need to be furnished to participants and beneficiaries or made available to them. In recent years, strenuous efforts have been made, with some success, to reduce paperwork burdens in both categories and efforts are still pending to determine whether electronic filing methods can be instituted to further mitigate such burdens. Nonetheless, controversy continues over the necessity of many of these requirements, whether effective compliance with the requirements is being achieved, and whether DOL, let alone participants and beneficiaries, makes effective use of the information received.

Insofar as DOL is concerned, the evidence seems to show that much of the information it receives is inadequate, inaccurate, not used at all or used haphazardly. In the case of Form 5500, for example, it is well-known that DOL has sold large quantities of these filed reports to private research organizations. The latter spend extensive resources to "clean them up" and make them usable. Once that is accomplished, they become a veritable goldmine of statistical data -- or so I am told -- which may have important implications for the study of broad retirement policy issues.

Presumably, all of this fascinating statistical data ultimately finds its way into the public domain where, if nothing else, it will serve to boost the careers of those who have expended their energies analyzing it. But the entire process not only raises questions about the abdication of DOL from significant research undertakings based on the 5500, but also about the necessity of statutorily mandated reporting for private research purposes.

In addition, questions are also raised about the reliability and necessity of 5500 data for enforcement purposes. On paper, a good case can be made for requiring financial data on an ERISA covered benefit plan to be submitted in a form separate from the independent accountant's financial statement pertaining to the plan and the applicable actuarial schedules, both of which ERISA also require to be filed with the 5500. Excluding the statistical justification for this approach, the rationale is that violations in the handling of funds can be more readily detected. However, practical experience would seem to indicate that the independent accountant's financial statement and opinion is probably just as useful in this regard. So it all boils down to this: does DOL really need the 5500 to adequately discharge its responsibilities under ERISA and, if not, with due regard for IRS requirements in this connection, why don't we dispense with it?

On the other hand, I see no similar justification for cutting back on vital communication links to plan participants and beneficiaries, such as the summary plan description and the summary annual report, and am inclined to the opinion that DOL has not paid nearly enough attention to seeing to it that Congressional intent has been carried out in these respects. Regardless of what many plan sponsors may think about how the average participant or beneficiary uses these documents, their transmission and updating in a timely fashion is essential to maintain employee confidence in the fairness and solvency of their plan and to educate them as to its workings. To the extent that these requirements continue to create burdens, especially for small business plans, greater technical assistance efforts on the part of DOL should be encouraged. If budgeted resources are too limited for this purpose, then it may be desirable to consider funding such a program by imposing minimum filing fees on all ERISA plans and/or using some portion of penalty payments collected for ERISA violations.

2. DOL Procedures for Granting Prohibited Transaction Exemptions. By way of background, prior to ERISA, the principal means by which conflict of interest transactions in pension plans were regulated was by the so-called "arm's length" test developed under the Internal Revenue Code. This test assumed that insider transactions involving such plans were justified as long as the plan paid or received adequate consideration with respect to the transaction. Ignored were the facts that all too often the "adequacy" of the consideration was determined by the insiders who would benefit from the transaction and that even if the arrangement was for "adequate consideration" there might be other factors that made it contrary to the best interests of the plan. Thus, for example, a loan from plan assets to bail out a failing plan sponsor might meet a narrow arm's length test but viewed in context would be imprudent. Since the temptation by insiders to engage in such transactions was and is very great, relying exclusively on general prudent man-standards was too much a question of closing the barn door after the horse had bolted. Moreover, the

impossibility of policing thousands of transactions to determine the adequacy of consideration paid or received made it highly likely that by the time the regulatory agency caught up with a deviant transaction, the damage to the plan would have already been done.

These considerations led to legislating in ERISA the so-called "prophylatic" approach to transactions between a plan and its insiders, under which these transactions were banned outright unless it could be demonstrated to DOL, under a specified exemption procedure, that an otherwise proscribed transaction would not pose a danger to the plan and, indeed, would be in the participants' interest.

To comprehend properly the controversy over the current exemption procedure, it also has to be understood that prominent segments of the private pension industry have fought to repeal the prohibited transactions approach ever since it was enacted, so that, once again, regulatory controls would revert to the ineffective "adequate consideration" approach. These efforts have been successfully resisted by every Administration to date in order to avoid a repetition of the long string of conflict-of-interest abuses in private pension plans that preceded ERISA.

The second level of attack then has been an attempt to demonstrate that the exemption procedure is time-consuming and unworkable. If the exemption procedure falls then so will prohibited transactions because the discipline imposed on fiduciaries by the latter would, in many instances, be too severe without the relief provided by the former. However, even the critics have to concede that DOL has made substantial progress in recent years in cleaning up its backload of exemption requests, and the fact is that no plausible alternative has as yet been presented which would provide the degree of protection against serious abuse that, despite its flaws, the present system offers.

It has been suggested that self-regulatory organizations, so-called SRO's, could assist DOL in speeding up the exemption process and providing technical assistance. Assuming the legality of this proposal, about which currently there is a great deal of doubt, it is still unclear whether the implementation of such a proposal would lead to greater or lesser efficiency, because, in the final analysis, DOL would still have to pass on the appropriateness of exemptions advanced by the SRO's in order to assure that DOL's mission under ERISA was not being compromised.

Nonetheless, SRO's may be a useful concept if their function is more clearly defined and limited to the processing of exemption requests from regulated service providers, such as regulated investment managers or advisors, banks, insurance carriers, etc. Exemption requests from these sources invariably have to do more with the practices and general regulatory treatment of the industry of which the service provider is a part, and the expertise involved usually needs to be more oriented to these matters than to the involvement with pension funds *per se*.

An even better alternative to the SRO approach might be to consider letting experts in the agencies that directly regulate these service providers, e.g., the S.E.C., the Comptroller of Currency, etc. handle their exemption requests. There is authority for adopting this procedure under ERISA Section 506, dealing with agreements for cooperation and mutual assistance between DOL and other federal or state governmental agencies. In my view, this approach would make the exemption procedure more efficient and still sufficiently protective of the interests of participants and beneficiaries to warrant dispensing with DOL involvement. Since service provider exemption requests are generally the most complex and time-consuming, the reduction of DOL's workload in this regard should have the beneficial effect of streamlining the exemption procedure for other users.

3. Fiduciary obligations in exercising the voting rights of stock held by pension funds. This issue has now come to the fore in light of the recent epidemic of corporate takeover

attempts. In its most frequent form the issue arises in the context of a hostile tender offer for control of a company whose stock is held by unrelated pension funds along with other unrelated investors. Since such tender offers invariably increase the value of the target company's stock does a pension fund fiduciary have the invariable duty to vote stock held by the fund in favor of the tender offer, and, if the target company's management adopts defensive tactics that frustrate shareholders from having the opportunity to vote in favor of the tender offer, does a pension fund fiduciary have the responsibility to actively challenge such tactics?

These are hard questions and there seems to be precious little law on the subject. It is, of course, a fiduciary's duty under ERISA to act prudently and in the exclusive interests of the plan's participants and beneficiaries but what that implies exactly in tender offer situations is open to argument. Ordinarily, it would seem that plan fiduciaries are obliged to vote in favor of a tender offer if it would increase the value of the target company's stock held by the fund. The fiduciary should not have to speculate on the fate of the target company and its value as an investment if incumbent management is ousted as a result of a successful takeover bid. It is sufficient if the fiduciary knows that at the time the tender offer is made it is in the interests of the plan as investor to accept it.

However, such an approach ignores the reality of some hostile takeovers which are stimulated by corporate raiders whose previous record indicates that their sole purpose is to strip a target company of all its valuable assets after the takeover is completed and leave it a corporate shell with little or no business future. To the extent such tactics become widespread and successful, they tend to reduce the availability to pension funds and other institutional investors of diverse and sound long-term investments. I believe that pension fund fiduciaries do not breach their ERISA obligations if, because of the prior track record of those making the tender, they decline to vote in its favor.

In any event, ERISA fiduciaries should try to do what is reasonable and within their limitations to prevent incumbent managements from depriving them of the opportunity as shareholders to act on a tender. However, I do not think that ERISA can be construed as requiring plan fiduciaries to lead a crusade in this respect and, therefore, the passivity of any given fiduciary on this score does not mean that a breach of trust has occurred. Instead, fiduciaries should be encouraged to be active in vigorously asserting their shareholder prerogatives, and this can best be done by assuring that the reasonable expenditures of plan funds in furtherance of this purpose is clearly sanctioned.

4. Fiduciary obligations in corporate takeover situations. The context here involves fundamental conflict-of-interest principles established by ERISA and the issue is whether those principles, as applied by DOL and the courts, are successful in protecting participants and beneficiaries against serious misuse of their funds. The point to bear in mind is that unless the fiduciaries of the plan with investment responsibility are totally independent of the plan sponsor, the underlying problem is almost always the same regardless of whether the situation involves the duty of a fiduciary to tender shares held by the plan in the plan sponsor who is the target of a hostile takeover bid, or whether the situation involves actions taken by the trustee to invest in stock of the plan sponsor so as to thwart a takeover bid or to invest in stock of a company which is the takeover target of the plan sponsor. In each of these instances, a pure investment decision on behalf of participants and beneficiaries cannot be made objectively because the fiduciary making the decision is also an agent of the vitally interested plan sponsor.

At this juncture, the law does not clearly and unequivocally require investment decisions of this kind to be taken out of the hands of the compromised fiduciaries and given over to those who have no stake in the outcome. Nor does the law clearly and unequivocally require the potential transaction to be brought to DOL as if it were a prohibited transaction requiring an exemption. There are a number of technical and, perhaps, practical, reasons for these deficiencies but they are not of overwhelming significance. The fact remains that litigation or the threat of litigation over whether the compromised fiduciary failed in putting the interests of participants ahead of the plan sponsor's is the sole weapon now available to DOL.

Moreover, plan sponsors can avoid this issue altogether by simply terminating their pension plan and using so-called "surplus" plan assets to make the investment decisions that ERISA might not let them make if the plan were kept alive. Since 1980, over 500 sizeable corporate pension plans have been, or are waiting to be, terminated, and over $6.2 billion in pension plan assets set aside for the benefit of workers have been recaptured by plan sponsors. A substantial reason for this grotesque development is the desire of incumbent corporate managements to ward off takeover attempts and entrench themselves by using pension fund assets or to remove the presence of overfunded plans as an attraction to corporate raiders.

In my view, the conventional litigation tactics employed by DOL are not adequate to stem this tide of real and potential abuse, and we should not be misled into thinking that they are because DOL appears successful in using them in particular instances. To do the job right, we should not have to wait until another decade of litigation has transpired in order to learn when compromised fiduciaries have really acted badly.

Accordingly, ERISA requires strengthening so that a cordon sanitaire is thrown up around employee pension plans during takeover struggles. By statute, decisions affecting the use of pension fund assets that will benefit plan sponsors in their takeover battles should be taken out of the hands of these compromised fiduciaries, and plan terminations designed to help incumbent managements entrench themselves should be effectively discouraged or disallowed. This is a matter of the highest priority because it greatly affects the integrity and effectiveness of private pension plan administration.

I commend the Chairman and Members of the Subcommittee for holding these valuable oversight hearings. They are much needed because there is still much to be done to improve the safeguards that ERISA established to protect the interests of over 35 million plan participants and beneficiaries. It should be very encouraging to working people everywhere that this Subcommittee has displayed such a keen interest in problems that vitally affect their material well-being when they retire, and I trust that the Subcommittee will continue to keep an eye on the issues discussed today because they are not going to disappear or be resolved overnight.

Senator COHEN. Thank you very much. The subcommittee will stand adjourned until tomorrow morning at 9:30.

[Whereupon, at 12:25 p.m., the hearing was adjourned, to reconvene at 9:30 a.m., Wednesday, June 26, 1985.]

DEPARTMENT OF LABOR'S ENFORCEMENT OF THE EMPLOYEE RETIREMENT INCOME SECURITY ACT [ERISA]

WEDNESDAY, JUNE 26, 1985

U.S. SENATE,
SUBCOMMITTEE ON OVERSIGHT
OF GOVERNMENT MANAGEMENT,
COMMITTEE ON GOVERNMENTAL AFFAIRS,
Washington, DC.

The subcommittee met at 9:28 a.m. in room SD-342 Dirksen Senate Office Building, Hon. William S. Cohen (chairman of the subcommittee) presiding.

Present: Senator Cohen.

Staff present: Susan M. Collins, staff director; Mary B. Gerwin, counsel; Kim Corthell, professional staff member; Frankie de Vergie, chief clerk; and Rachel D. Harlan, assistant chief clerk.

OPENING STATEMENT OF SENATOR COHEN

Senator COHEN. The hearing will come to order.

Today, the subcommittee is continuing its oversight hearings on the Department of Labor's enforcement of the Employee Retirement Income Security Act, the Federal law that protects the rights of more than 73 million workers and retirees covered by private pension plans.

Witnesses testifying before the subcommittee yesterday identified serious flaws in the Department's enforcement of ERISA. They told the subcommittee that:

The Office responsible for ERISA within the Department of Labor lacks the budget, staff, and clout necessary to enforce the law effectively;

The chances of a plan being audited or investigated by the Office is miniscule; consequently, many individuals who violate ERISA are neither detected, nor deterred;

The data which the Department relies upon is usually out-dated, often incomplete, and of little use to investigators; and finally,

The prohibited transaction exemption process is bogged down, but there is no consensus apparently on what the remedy ought to be.

Other issues explored yesterday at our hearing concerned the obligations of pension plan fiduciaries in voting shares and in corporate takeover situations. The three former administrators of the DOL Pension Office, as well as another leading expert, all agreed that a fiduciary must examine corporate governance issues in order to ensure that the interests of the plan's beneficiaries are fully protected.

In view of this agreement on the requirements for ERISA, the testimony that conflicts of interest abound in the handling of pensions was most troubling. Jeffrey Clayton, for example, one of the former Administrators, testified that "for too long, there has been too cozy a relationship between some institutional fiduciaries and the companies whose stock those institutional fiduciaries are voting."

Another former Administrator, Robert Monks, spoke of the "extensive overlapping networks of 'connected' companies who have commercial relationships with virtually every significant financial service provider."

Their views were echoed by another witness who pointed out that conflicts of interest are inherent when the plan sponsor is the target of a hostile takeover bid, unless an independent trustee is appointed. The subcommittee learned that, in the heat of a takeover battle, pension funds themselves may be a tempting target to be used either defensively or offensively.

Given the tremendous growth in assets held by pension funds and the expectation that these assets will reach $2.4 trillion by the end of the century, the strong evidence of the Department's problems in enforcing the law is cause for great concern.

Through these hearings, the subcommittee hopes not only to identify the deficiencies in the present system, but also to formulate recommendations. The witnesses we will hear from today will help us, in my judgment, better grasp both the problems and their solutions.

As our first witness, I'm pleased to welcome Francis Lilly, the Solicitor of the Department of Labor, who will present the Department's views on the enforcement of ERISA. Mr. Lilly is accompanied by Alan Lebowitz, the Acting Administrator of the Office of Pension and Welfare Benefit Programs.

Before you begin, Mr. Lilly, I might apologize by way of introduction. I'm told that we're going to be voting before 10. I suspect, if last night's pattern of voting continues throughout the morning, that the Senator from Ohio will call us over about every 15 or 20 minutes, until we resolve the issue of imputed interest.

So with that in mind, please be patient and I hope that all the witnesses who are here today will bear with us as we try to work through the morning.

Why don't you begin?

TESTIMONY OF FRANCIS X. LILLY, SOLICITOR, DEPARTMENT OF LABOR, ACCOMPANIED BY ALAN D. LEBOWITZ, ACTING ADMINISTRATOR, OFFICE OF PENSION AND WELFARE BENEFIT PROGRAMS

Mr. **Lilly**. Thank you, Mr. Chairman. Let me also begin by apologizing to you and to the subcommittee staff for our tardiness in providing you with the prepared testimony.

My wife refers to me oftentimes when I arrive home late in the evening as the "late Mr. Lilly." [Laughter.]

I will once again plead guilty to that charge with regard to the testimony.

Also, Mr. Chairman, in accordance with your request, I will summarize my prepared testimony, but I would request that my full statement be included in the hearing record.

Senator COHEN. The full statement will be included, Mr. Lilly.

Mr. LILLY. We are pleased to be here today to discuss the Department of Labor's implementation of its responsibilities under the Employee Retirement Income Security Act of 1974, which you have referred to as ERISA. Accompanying me today is Alan Lebowitz, the Acting Administrator of the Office of Pension and Welfare Benefit Programs, which I will refer to as simply PWBP.

At the outset, let me state that Secretary Brock has asked me to express to you his deep commitment to the pension program. He has stated many times that this program is one of his top priorities and that he intends to devote a great deal of time and energy to it.

To emphasize the importance of this program, the Secretary intends to elevate, as you indicated yesterday, the position of Administrator of the Office of Pension and Welfare Benefit Programs to the rank of Assistant Secretary. He is hopeful that an individual to fill that position will be on board before the August recess. The Secretary will work closely with the new Assistant Secretary to examine and evaluate all matters relating to the Department's role in ERISA. Secretary Brock's commitment is firm and he looks forward to working with you, Mr. Chairman, the members of the House and Senate Labor Committees, and all other interested committees on retirement income issues.

As you indicated, the purpose of ERISA is to protect the 73 million workers in the Nation's 785,000 private pension plans and the assets of those plans of almost $1 trillion from the abuses that have historically plagued the pension benefit world and to enhance the retirement income of American workers. There can be no doubt that due to the enactment of ERISA by Congress and the administration and enforcement of ERISA by all involved agencies, our pension system is on much firmer ground today than it was only a short 11 years ago. A system is in place that, although not perfect by any means, provides valuable protections for these people and their assets.

Because of the magnitude of the universe affected by ERISA, it is imperative for the Department to constantly review and assess what we have accomplished in the past and to determine what needs to be done in the future. We have recently engaged in such a process, both internally and in more public forums, such as the National Pension Forum. I will discuss the results of some of these reviews in more detail later in the testimony.

In addition to our own reviews, our activities have been reviewed by others as well. For example, on numerous occasions, we have been the subject of oversight hearings such as today's, and we have received valuable insights from these experiences.

After the enactment of ERISA in 1974, it was necessary to shape first the statute's goals into the practical reality of a program to impelement these goals. Much of the first 6 years of ERISA was spent by the Labor Department, the Internal Revenue Service, and the other agencies involved in interpreting the statutory language and the legislative history and in coordinating their respective roles.

When this administration took office, former Secretary Donovan pledged that the enforcement of ERISA was to be given high priority and high visibility within the Department. As part of that effort, and under the leadership of, among others, former Administrator Robert Monks, PWBP, engaged in the process of internal review and reorganization in order to enhance the Department's administration of its responsibilities under ERISA.

I would like to briefly mention two such recent reviews.

In 1984, a special ERISA enforcement task force was established by the Secretary to review all aspects of the Department's enforcement responsibilities under the statute. A working group of the task force concluded that, despite many notable successes in the past, the Department's ERISA enforcement activities lacked sufficient credibility both in the employee benefit plan world and in the executive and legislative branches of the Federal Government.

The task force determined that this problem was primarily the result of a lack of sufficient resources to effectively establish credibility, as well as less than optimum use of the resources which had been allocated.

The task force's report, which has been delivered to the Secretary's office and is awaiting his and the new Administrator's review, suggests improvements which, in its view, are necessary to provide the Department of Labor with a credible, overall enforcement program.

In addition, in 1984, on the 10th anniversary of ERISA, former Secretary Donovan convened the National Pension Forum. The forum recently completed its work and has submitted its findings to the Secretary's office as well. The forum recommended, among other things, the computerization of the ERISA information management system, that the Secretary extend to PWBP the necessary hiring authority to permit the hiring of lawyers in the pension program at the investigative level, that the Department explore the concept of a self-regulatory organization, which was discussed here with you yesterday, Mr. Chairman, that the Secretary create an Office of Pension Statistics, that the Secretary designate the principal officer of PWBP as an Assistant Secretary, and that the Secretary continue to devote resources for public outreach and assistance.

As I will note, the Department is currently in the process of implementing some of these recommendations. The other recommendations will be reviewed by the Secretary and the new Administrator. One especially significant result of our internal reviews has been the reorganization of the office of PWBP.

Following the passage of ERISA in 1974, the Secretary of Labor's responsibilities were, for the most part, delegated to the LMSA, the Labor Management Services Administration. In January 1984, the Secretary signed an order making the Office of Pension and Welfare Benefit Programs an independent agency within the Department of Labor with the Administrator reporting directly to the Secretary.

A new division of investigations was established within the national office of PWBP to undertake investigative activities in certain areas, including nationwide, high visibility and/or precedent-setting civil and criminal investigations.

In addition, in order to eliminate overhead and to utilize resources more directly, PWBP's field offices have been consolidated into 10 area offices and 5 district offices. These area offices, for the first time, report directly to the PWBP national office. PWBP's overall program of investigations is designed to identify and correct violations of ERISA, as well as to serve as a deterrent against abusive practices.

The greatest emphasis is placed on fiduciary investigations, but PWBP also performs limited plan audits, conducts reviews of compliance with bonding and reporting requirements, and investigates criminal violations of ERISA and related laws.

Criminal investigations conducted by PWBP resulted in 10 indictments this year.

In fiscal year 1984, the Secretary recovered plan assets and set aside prohibited transactions involving $93 million.

On the regulatory side, ERISA, in comparable provisions of the Internal Revenue Code, specifically prohibits a plan from dealing with certain insiders known as parties in interest, unless the transaction is exempt. If no existing statutory or class exemption exists for the transactions, the parties may apply for an individual exemption.

As originally enacted in ERISA, the processing of all exemption applications involving prohibited transactions under section 406 rules was conducted jointly by the IRS and the Department. Because of the delays in processing these applications, public and congressional concern mounted as to the feasibility of the administrative exemption procedure.

In an effort to expedite exemption processing, reorganization plan No. 4 of 1978 transferred authority to issue exemptions for most cases from the Secretary of the Treasury to the Secretary of Labor. As a result of the reorganization and the grant of precedential exemptions covering typical transactions between plans and parties in interest, the Department has greatly increased the number of individual exemptions closed while reducing the average case processing time for both approvals and denials to under 5 months per application.

The dynamic growth of new financial instruments, however, guarantees continuing pressure on the Department for timely issuance of these exemptions. Some of the cases involving such major issues as shared investing between plans and fiduciaries, the establishment of performance compensation arrangements and particular requests for retroactive relief have encountered delays.

Although these issues are very complex, these matters are proceeding steadily toward resolution.

Consistent with budgetary restraints, we have carefully recruited personnel so as to enhance the professionalism of the exemption division and its ability to keep pace with its increasingly complex inventory. As was recommended by the National Pension Forum, the Department is currently working toward obtaining schedule A hiring authority for PWBP in order to permit the hiring of attorneys in the program.

Congress also authorized the Secretary of Labor to promulgate exemptions for classes of transactions, each of which affects broad economic areas, where appropriate findings assure the protection of participants and beneficiaries.

Since ERISA's enactment, numerous class exemptions have been issued. The qualified professional asset managers' class exemption is a good example and is discussed in fuller detail in my submitted statement.

ERISA also imposes detailed requirements on plan sponsors to file annual reports and to prepare plan descriptions and to file and distribute summary plan descriptions. The design, distribution, technical assistance, receipt, and processing of these required reports require PWBP to allocate a significant share of its total resources for the purpose of management of this data base.

The major ERISA report is the annual report series, form 5500, that you discussed yesterday. Approximately 960,000 plans will submit the 1984 5500 series report, including the shorter forms filed by small plans.

In addition to the annual report series, PWBP receives several other reports from plan sponsors. Much of the information contained in these required submissions is essential to the work of PWBP. Reliable and timely information is required to carry out the agency's statutory responsibilities of policy formulation, enforcement, and public information.

PWBP has completed a pilot project to demonstrate the feasibility of the electronic submission of ERISA data. If this project is found to be successful, the Secretary may investigate ways to obtain further funding for electronic filing.

The Department is authorized under section 513 of ERISA to undertake pension research and surveys, and to collect, compile, analyze and publish data and statistics relating to employee benefit plans.

Despite the fact that the resources of the research program have fluctuated over the years, much significant research has been completed. A major study, entitled "Pension Economics," was completed in February 1985. This study, which assembled available pension data and economic research on pensions, addressed the development of the pension asset base, its potential for further growth, and its implications for labor and capital markets in the long run.

In 1984, PWBP began a major project to develop, maintain, and analyze form 5500 data. This is a continuing project to establish and maintain an historical data base of a large sample of form 5500 reports. The data entry and editing of a large sample of the 1981 and 1982 filings is expected to be completed under contract during fiscal year 1985.

Another example of research undertaken is a detailed report analyzing the benefits currently paid to retirees and beneficiaries. In addition, in January of this year, PWBP conducted hearings focused specifically on the issue of pension investment performance and corporate governance. Those giving testimony came from both the academic and business sectors, and included some of the foremost authorities available.

The hearings brought forth a variety of conflicting views and suggestions as to the issues examined in the two fields and provided a valuable record for future reference and study.

Another PWBP initiated in March 1980 provides assistance to plan participants and beneficiaries in securing benefits which they have otherwise been unable to obtain from plan sponsors. Through this program, PWBP has helped to obtain benefits for participants and beneficiaries in an amount of about $12 million. Along with the significant reforms and developments in the Department's administration of ERISA, we in the Office of the Solicitor have pursued and brought to successful completion a number of important enforcement cases. As a result of our litigation efforts, we have obtained notable results, including numerous judgments restoring large amounts of money to pension plans, injunctions to prevent illegal transactions from continuing, removal of breaching fiduciaries, and remedies which seek to prevent future abuses from occurring.

In light of the time limitations, I will forego in my summarized statement the indepth discussion in which I would take great pride in discussing the success we've had in the Solicitor's office in these case.

I will just mention that we are especially proud of what we've accomplished in the Central States, pension and health and welfare funds cases, and in the litigation which involved loans made by the Southern Nevada Culinary & Bartenders Pension Trust to companies controlled by Morris A. Shenker. In that case, last year we obtained a judgment in favor of the trust fund in the amount of $36½ million, which we're attempting to collect on now.

I would also note that we have devoted considerable time and energy of late to a different type of case which has resulted from the charged atmosphere on Wall Street surrounding the escalating number of corporate take-over attempts and mergers. In our leading case, now styled *Brock* v. *Bierwirth,* we are continuing to litigate over the propriety of actions taken by the trustees of the Grumman Corp. pension plan to assist Grumman in opposing a hostile take-over attempt by the LTV Corp.

In two other cases, we have successfully established the principle that pension plan assets cannot be used to promote take-over attempts by the plan's sponsoring company. In addition, we are continuing to examine the increasingly frequent practice of involving employee stock ownership plans, known as ESOP's, or similar arrangements in leveraged buy-outs usually designed to avoid take-over threats.

In two notable situations involving buy-outs of large publicly held corporations, we have issued enforcement letters which set forth our views on the duties of plan fiduciaries and resulted in significant improvements in the plans' investments.

Mr. Chairman, these are some of our achievements in the implementation of ERISA. I would especially note the contributions made by the three former administrators who appeared before you yesterday. Their jobs were difficult, indeed, and I'm sure at times seemed thankless. Their efforts resulted in greater security for plan participants and beneficiaries.

I am sure that the subcommittee appreciates the fact that the issues the Department faces under ERISA are many, varied and increasingly complex. We are determined, however, to enforce ERISA in a fair and objective manner and we are determined that the essential rights of participants and beneficiaries will be protected.

In conclusion, I would like to reiterate Secretary Brock's deep commitment to the pension program. Under his leadership, we will discharge our obligations and responsibilities under ERISA vigorously.

I would like to thank you for allowing us this opportunity to appear before you today. We would be pleased to try to answer any questions you might have.

Senator COHEN. Thank you very much, Mr. Lilly.

What strikes me about these hearings is that I've been really impressed with the quality of the people who have served as administrators in the past and, indeed, the quality of the people who remain within the Department of Labor, I might say under very trying circumstances. To go back over the past 4 years, we've had a Secretary under attack almost daily with questions about stability of the management, management turbulence, inadequate resources, and divided jurisdiction.

I was thinking yesterday of that classic comment of Dr. Johnson, in observing the walking dog—not that he does it so poorly, but he does it at all. [Laughter.]

That applied in this case, in particular, in my mind, at least.

There are a number of issues that were raised at yesterday's hearing. I am by no means an expert in this field, as I tried to indicate yesterday, but it seems to me that the testimony ultimately comes down to the following issues: is it in the long-term interest of the ERISA Program to have jurisdiction divided among three different agencies or should we have a single agency; should there be an independent trustee to resolve conflicts-of-interest questions; should we have an SRO to resolve criticisms of the prohibited transaction exemption applications or should there be an advisory council as an alternative; should we have a greater class exemption or should we facilitate the individual exemptions and how would we do that; should we move to electronic filing with respect to the 5500 form; and is there a long-term policy? Apparently, GAO has concluded that there is no long-term policy within the Department of Labor, for the ERISA Program. There are other questions dealing, for example, with asset reversion schemes. To what extent should we try to make statutory changes, and how would those statutory changes affect the voluntary nature of the plans themselves?

These, it seems to me, are the essential questions. I'll try to confine my own questions to these issues.

I agree with your statement that it's important that we have reliable, timely information in order to carry out the Agency's statutory responsibilities and policy formulation. I don't believe there is any disagreement on that particular statement. The question is are we getting reliable, timely information? The record would seem to indicate that we're not.

With respect to the 5500 form, for example, there appears to be at least a 1-year delay, perhaps even longer, before the Department of Labor has access, or at least working access, to that information.

Field offices, I am told, are currently relying upon 1981 filings for their source of information. It is certainly not anything that's contemporary.

The question is, What are we going to do about getting reliable, up-to-date, complete information? It was pointed out yesterday, for example, that the IRS gets the first shot at the 5500 form. They take 7 months and, even though it may be incomplete data that is furnished to the IRS, that information is then microfisched onto DOL. If there is additional information that comes to the IRS, that information is never sent on to DOL. So you've got incomplete information, unreliable information, and it's later, much later than the late Mr. Lilly. [Laughter.]

How do we correct that situation?

Mr. LILLY. I'd like, Mr. Chairman, to address a couple of issues very briefly and then ask Mr. Lebowitz to comment on that as well.

Obviously, some of the things in terms of the questions you have raised implicate broader policy decisions that are outside of the realm of the Department of Labor alone. As I mentioned, the electronic filing project was undertaken to survey whether or not electronic filing was feasible. The report on its feasibility in a study done by the Mitre Corp., as I understand it, is currently under review at OMB. It has put together a task force to examine this very issue, of whether or not there is a more efficient, less expensive, and more useful way of making all of this information available to the various agencies that have to use it on a much more expedited basis.

I think that the effort undertaken by the Department was a first step in this direction and one which I anticipate the new Administrator will pick up, take the baton on, and continue running as fast as he can.

Senator COHEN. My understanding is that the program ends today.

Mr. LILLY. I think that some amount of the funding in terms of the electronic pilot project—I understood the same thing, that some funding somewhere ran out today.

I don't think, however, that that means that the electronic filing project is by any means dead or even dormant. I think that the contracting money is at an end at this juncture, that the Mitre Corp. report is under review and that the OMB group is going to be reviewing this entire question and seeing whether or not there is something feasible that could be done as soon as possible.

Alan?

Senator COHEN. Mr. Lebowitz.

Mr. LEBOWITZ. It isn't so much, I think, that the money runs out today as it is that the tasks that we had contracted with Mitre to perform have largely been completed.

There are a few details, I think, that they have to clarify in some of their draft reports. So it isn't really a matter that the dollars have run out, but everything that we've asked them to do is completed, awaiting what is essentially, I would suggest, a policy decision whether to go forward with the construction of the system on a multiagency basis.

Senator COHEN. While you're analyzing the viability of electronic filing, what other option is there?

In other words, if you have the same system that we have today, where we're really nowhere in terms of having adequate, reliable information, what would be a viable alternative to electronic filing?

We're living in the age of computers; is there any other option?

Mr. LEBOWITZ. I'm not sure that I could offer any at this point. In relative terms, we're reasonably well off as compared to the way the system was working a few years ago.

Part of the——

Senator COHEN. You're a year or two behind the ball in terms of the 5500 form today.

Mr. LEBOWITZ. Well, the statute itself doesn't require the information to be filed with the Government until 7½ months after the close of a plan year. So that means that we have not yet begun to receive information for plans whose years end on a calendar year basis for 1984.

We begin—as you pointed out, the information is filed on behalf of all of the agencies with the IRS.

At the outset of ERISA, for the first couple of years, these forms were filed with both the Internal Revenue Service and the Labor Department. And a judgment was made at the time that that was too burdensome on the filing public to require them to send what often is a bulky, long form to two separate agencies.

Senator COHEN. Six pages, with some additions.

Mr. LEBOWITZ. Attachments, and it can be very long in the case of a large plan.

As a result of those kinds of concerns, the judgment was made that it ought to be filed with the IRS that has the capacity for receiving large amounts of paper and processing it through their system.

Over the years, we've worked with the Service to try to make the system work as efficiently as it can.

Senator COHEN. The testimony is that it's not working. That's what I'm——

Mr. LEBOWITZ. Well, we do receive—I don't know——

Senator COHEN. I don't know how you can function or how anybody in this room could function under such circumstances. How many plans are there? 780,000 plans? If I had to wait for 2 years, it's like reading old newspapers.

Mr. LEBOWITZ. Well, they don't come in bulk in the sense that they don't all, they aren't all processed at the same time and all sent over to the Department at the same time.

Under the present system, the IRS will process the forms and as they extract the data that they take off of the form and put it onto computer tape, they'll send it over to us on a quarterly basis.

Typically, that means that we will begin to receive data, for example, for the 1984 filings on computer tape around December of this year. And then on a monthly or quarterly basis, we'll get updated tapes until the process is completed, probably not for another year.

So it's probably not completely processed until, again for the 1984 example, until December 1986. But at least we will have gotten some information on an ongoing basis over that 15-month period that we can and do utilize for our various purposes. It's not complete information and we obviously would like to have it sooner. But it's not a situation where we have nothing to work with at all until 2 years after the time that the information is filed.

The copies of the forms themselves lag behind the tapes about a month or two. When the service finishes processing them, they go to our contractor, where they are microfisched and then the fische are sent to us for filing and our own purposes, as well as having them available to the public.

Senator COHEN. Did the task force make any recommendations about changing the contents of the 5500 form? We had some testimony yesterday that the information may either be unnecessary or, indeed, even irrelevant, and that before we move toward any sort of standardized electronic filing system, we ought to first determine whether the form itself and the contents ought to be changed.

Mr. LILLY. Yes, Mr. Chairman. In fact, the National Pension Forum has included that as one of its recommendations.

If I may, two other brief points. First, I think it's important to recognize that, again, 11 years ago, when ERISA was passed, we were dealing with grossly underfunded or nonfunded plans. The problem we're having with terminations and reversions is that there's too much money in these plans. In a sense, that's a nice kind of problem to have in one aspect.

Likewise, in the reporting area, we again are dealing with a surplus of reports because everybody is basically, we believe, filing their reports. The question is, How can we more efficiently and promptly deal with those reports? And I think we have to face that issue as one that we have to deal with immediately and I think we're trying to.

In that regard, I'd like to note, second, that the Vice President's Task Force on Regulatory Relief, back in 1981 and 1982, and I think at that juncture the former Administrator, Mr. Monks, was on that task force participating in that effort, reviewed these forms among many others. They recommended I think, what would be some improvements in the information that was requested and I think that the Department, through PWBP will be taking another look at that to see if it can be further streamlined in conjunction with the electronic filing project, if that goes forward.

Mr. LEBOWITZ. If I might add, we are in the process now of conducting an indepth review of the form to make it both compatible with the possibility of electronic filing and to determine that the information that we are asking people to provide to us is the kind of information that we need and that we will use.

Much of the information on the form, I would note, is required by statute and there isn't an awful lot of discretion that the agencies have as to whether or not to request it.

Senator COHEN. One of the other comments yesterday is that the Department itself has given too little of its own limited resources to the ERISA Program, and that what we have witnessed is a decline of about 250 employees down to about 178. There has been also a corresponding decline in budget for the Pension Office. In addition, Congress increased your burdens by imposing criminal investigatory responsibility.

Do you think that giving the Pension Office a line item in the Department of Labor's budget would be a helpful step?

Mr. LILLY. Mr. Chairman, I would like to defer that one to Mr. Lebowitz, but he probably won't take it. [Laughter.]

I think that in terms of not being a budget expert—I get into a lot of things down there, but budget is not one—I think that the former Secretary's commitment to this and the current Secretary's commitment to this is an indication that they're going to be taking a look at what budgetary resources they can possibly allocate to the program, and if their budget experts think that the line item is a good idea, I'm sure they'll proceed on it.

Senator COHEN. You may recall, if you were here yesterday, that there was some disagreement among the panelists who were testifying. Mr. Lanoff, I believe, indicated that there were many competing priorities within the Department.

In my judgment, pensions are just as important as mine safety, for example, or, indeed, even OSHA, particularly when you talk about the number of dollars involved and the potential for abuse.

So, to say ERISA doesn't really measure up to mine safety or occupational safety or other Department priorities, I think, ignores the potential for abuse.

Following the hearings yesterday, a young reporter asked me: Why are you holding these hearings? Nothing major has happened yet. There's been no major scandal.

And I said, do we have to wait for the hijacking of another TWA aircraft before we hold hearings as to what needs to be done to have better security at airports?

It's the same sort of problem, I think, that we have here. There is a tremendous amount of money flowing into these funds and because of either lapses in statutory language, division of authority and responsibility, inadequate resources, old information, or perhaps questions about corporate governance, we have the potential for a major scandal.

I suspect that the hypothetical offered by Bob Monks yesterday is not hypothetical. I believe that, in fact, those kinds of situations occur almost on a daily or, indeed, weekly basis, and have yet to come to light.

That is the reason I think we ought to be elevating this particular facet of the Department of Labor's responsibility to a much higher visibility. It is important now and it is going to assume more and more importance in the future.

I don't know if the answer is elevating the position of administrator to assistant secretary. I think it's a very good step, but I think we have to do a lot more than that.

Were you involved in the task force this past year?

Mr. LILLY. The enforcement working group?

Senator COHEN. Yes.

Mr. LILLY. The Secretary set up a task force comprised of the——

Senator COHEN. Pension Office, Solicitor's Office, Inspector General's Office.

Mr. LILLY. Right.

Senator COHEN. You reviewed the Labor Department's enforcement of ERISA?

Mr. LILLY. Right.

Senator COHEN. You personally were involved?

Mr. LILLY. I was personally involved with the IG and with Mr. Monks in the review of their work. Representatives from the Solicitor's Office participated extensively in the working group of the task force, itself.

Senator COHEN. Do you intend to recommend to the Secretary that you get additional resources for the enforcement of the ERISA program?

I know he's going to call on people like you. I talked with Secretary Brock, and he is just putting his feet into the water and is really going to be relying upon the recommendations coming from those who have had a lot of experience. What is your recommendation going to be?

Mr. LILLY. My recommendation, I think, is probably best demonstrated—what my recommendation would be would probably be best demonstrated by the fact that I will claim no small amount of credit or blame for enticing Mr. Monks to join us down at the Department of Labor previously. I think the fact that he joined us and the kind of spirit and energy that he brought is extremely important and I'm looking forward to the same kind of spirit and energy from the Secretary's new appointment to be the new Administrator and Assistant Secretary.

I personally believe that the ERISA Program is very important. As you pointed out, there are obviously other very important programs at the Department. I think that in looking at the amount of money that is involved and in looking at the retirement security of the number of people who will be depending on ERISA plans for their retirement income, the various situations discussed with regard to social security, the problems with savings—I think it's an extremely important program which is going to be growing, both in terms of the demands being placed upon the Department of Labor and the resources which I think the Department of Labor will allocate to satisfy that demand.

Senator COHEN. The Enforcement Working Group recommended a number of changes to improve criminal enforcement efforts, including closer contact between the investigators and the prosecuting attorney during the investigative stage.

Do you support that as well?

Mr. LILLY. I think that that would be a good idea. I'd like Alan Lebowitz to comment on that because he's more directly involved with the process itself.

Mr. LEBOWITZ. I was a member of the working group of the task force and supported that particular proposal.

Mr. LILLY. We do, I might point out, Mr. Chairman, to the greatest extent possible, have our people coordinate with the appropriate prosecuting attorneys in every possible instance. But oftentimes, like in a lot of other things involving various bureaucracies, that gets tangled.

Senator COHEN. The working group also pointed out that the so-called agreement between the IRS and the Department of Labor for imposing excise taxes on prohibited transaction violations may not be working. They found, for example, that the IRS has not imposed excise taxes on most of the cases referred by the Department of Labor.

Is this a major problem and, if so, how do we correct it?

Mr. LEBOWITZ. Well, clearly, the excise tax is an important critical element in the overall enforcement scheme that Congress devised in enacting ERISA. The Department has various sanctions that it can bring to bear seeking equitable relief, as Mr. Lilly mentions, removal of trustees injunctions, recovery of lost assets, et cetera.

But the excise tax is a particularly powerful disincentive to abuse since it applies automatically and can be imposed in a relatively simple administrative process by the service. So, it's been our objective over the years in working with the IRS to try to encourage them to move as quickly as they can with our referrals.

I don't have any definitive data on how many cases we've referred and how many they have acted on. I have some statistics of the number, the amount of money they've collected as a result of cases we've referred to them in excise taxes and it's gone from $556,000 in fiscal year 1983 to $1.7 million in fiscal year 1984 to an estimated $5.4 million in fiscal year 1985. The number of cases has gone up about three times as well.

So, it would appear, at least from those numbers, that there's more activity in that area. I think that it's very important that they continue to pursue the matters raised when we refer cases to them.

Senator COHEN. One of the recommendations made yesterday was that the Department come forward with a policy statement with respect to corporate governance issues and also fiduciaries responsibilities.

Do you support such a policy statement coming from the Department of Labor?

Mr. LILLY. Well, I think, from my perspective, Mr. Chairman, that we've already made a few policy statements with regard to the issue of fiduciary responsibilities, quite a few, both through these letters that I mentioned in the testimony in terms of the corporate take-over, merger, the leveraged buy-out area.

With regard to the corporate governance area, I think that there is quite a bit of disagreement with regard to what ought to be done there. I was happy to be able to participate in the hearings that former Administrator Monks conducted in New York in January. And I remember that one of Mr. Monks former law professors from the Harvard Law School, Prof. Joseph Auerbach, pointed out that, in his opinion, the trustees' obligation was to vote with their feet and not try to get into the issue of what were the corporations doing with the stock, that their main duty, as a fiduciary, was to maximize the amount of return on the holdings, and if that meant they didn't like what the company was doing, to sell the stock and get out.

That was one of the experts. There were experts on the other side. I think Mr. LeBaron, who will be testifying here today, had a different view. And I think that's the kind of discussion that we're engaged in right now and has to be very carefully done because, as you so aptly point out, with $2.4 trillion or whatever it is, that's estimated to be in these funds by the year 2000, some estimates are that of the stock and debt on the New York Stock Exchange, these funds will own 48 percent by that same time.

Therefore, I think we have to be very, very careful in taking a look at what kind of general, off-the-cuff statements ought to be made by the Department of Labor or anyone else with regard to that activity.

Senator COHEN. That's just the point. Rather than general, off-the-cuff statements, should we have a policy statement that has evolved from within the Department of Labor? I think one of the criticisms has been that as Administrator, Mr. Monks would make a speech or prepare a paper, for example, talking about brokerage commissions and soft dollars. Should the Labor Department have a policy statement with respect to that type of transaction?

Mr. LILLY. Well, I think that with regard to the ERISA issue and the corporate governance, that such a policy statement would come out of the administration because of all of the agencies involved in the administration's enforcement of ERISA. And I think those kinds of reviews are currently ongoing.

Senator COHEN. Mr. Lebowitz, my staff just handed me a note that 123 referrals from DOL involving prohibited transactions have been closed by the IRS, 107 closed with no action, and only 16 resulted with the imposition of a tax. That was the basis for the initial question. It doesn't seem to be much in the way of a response from the IRS.

Mr. LEBOWITZ. We encourage them as much as we can.

Senator COHEN. What steps has the Department taken to promote understanding of and compliance with ERISA's fiduciary standards in voting stock held by pension funds?

Mr. LILLY. Well, if I understand the chairman's question correctly, we have taken action in a couple of cases where the issue has come up vis-a-vis corporate takeovers. We have sent letters and we have indicated in statements by the Administrator and others that the fiduciary's responsibility will continue with regard to the actions taken by fiduciaries with regard to the stock held by plans.

With regard to any kind of general overall policy statement as to what ought to happen, I think we're approaching that currently on a case-by-case basis as to what are the facts and circumstances of any individual action.

Senator COHEN. What do you think about the proposal of requiring a disclosure of fiduciaries' voting patterns or policies or, indeed, individual votes? We're going to have a witness testify later this morning who indicates that his firm does, in fact, publicly disclose votes as a matter of policy.

In your judgment, would that be something that the Labor Department is willing to investigate in terms of making it a policy?

Mr. LILLY. As I understand the proposal that was articulated yesterday, that would require the money managers to disclose, and I take it it was publicly, what their votes were with regard to the pension plan stock.

That seems to me to be, again, an evaluation that the fiduciaries themselves have to make as to whether or not that would be in the plan's best interest and if so, then they ought to require that.

If the disclosure of which way they voted could, in fact, damage the investment that they had in that particular stock, then I think there's a different situation.

I think that at this juncture, when that proposal, if and when that proposal is actually given to us or we undertake it on our own review as a result of these hearings, we will study it and see whether or not it's the type of thing that either requires or encourages some kind of a policy statement by the Department.

Senator Cohen. Yesterday we heard testimony that the conflicts of interest faced by money managers may be fairly extensive because of interlocking directorships, interlocking interests, and holding a number of portfolios in various interlocking companies. How extensive, in your experience and judgment, is this problem?

Mr. Lilly. I'd like to ask Mr. Lebowitz to address that, if I may.

Mr. Lebowitz. Well, I don't think we've ever investigated that subject by itself. Just on the basis of what's available in the public domain, I would imagine that there are extensive aspects of interlocking directorships and interests that cross corporate lines, et cetera.

Senator Cohen. Don't you think that is worthy of an investigation on the part of DOL, to find out how pervasive the problem is as outlined by Mr. Monks yesterday? In Mr. Monks' hypothetical, the money manager for company A's pension plan also manages the pension portfolios of 10 other companies, and has purchased company A stock for all 10. A call from company A comes through saying, we're depositing an additional $10 million in pension funds for your to manage and, by the way, would you put your votes in for a proxy on behalf of the management?

Mr. Lebowitz. I think that issues like that need to be explored by us in the context of our enforcement responsibilities. They are, quite obviously, very complicated and subjective kinds of issues. The standards of proof, I would suppose, for successful enforcement in a matter like that are going to be very difficult to sustain.

But I would agree that where we have indications of a conflict of interest, that we should pursue it.

Senator Cohen. Mr. Lanoff was critical of the amount of training given to the staff. In a report that was issued this week, the GAO noted that the training for ERISA professional staff has been limited and inadequate for the past 7 years. Do you agree with that assessment?

Mr. Lebowitz. I think that our training efforts have been spotty. I would agree with that. We have, at various times, devoted substantial amounts of time and effort and resources to it and at other times, not very much at all.

What we're trying to do now and what we have done at the moment is to review the entire training situation that's existed over the years and to develop a comprehensive program that would be available to our investigators and national office people from the time they first become employed by us and then on a continuing basis through their entire career.

We expect to have the components of that training program developed within the next few months and to begin implementing it next year, in the next fiscal year, with, hopefully, the first class of new hires to go through it sometime in the late winter or early spring.

Senator COHEN. Let me just turn quickly to SRO's. What is your basic recommendation with respect to dealing with the exemption process? It is pretty clear that it takes an inordinate amount of time for class exemptions. It might run as long as 2 or 3 years. For individual exemptions, it is certainly 6 months, perhaps longer. I assume most of the professionals in the field would testify that that is too long. Investment opportunities are being lost. What would be your recommendation for dealing with the exemption process?

Mr. LILLY. Let me just briefly address that and then ask Mr. Lebowitz to.

I think that the exemption process, as contemplated by Congress, requires governmental activity and final governmental decisionmaking.

Senator COHEN. I should point out that I think Mr. Michael Gordon might have a different view and that is the governmental policy was one of deliberate slowness, or at least caution, so that the exemptions aren't granted too quickly, thereby undermining the basic purpose of protecting the beneficiaries' interest.

So, while it is not a unanimous view, it seems to be the majority view that the process is too long, too cumbersome, and not working effectively.

Mr. LILLY. I think, Mr. Chairman, any time you have a pot sitting out there and people trying to do something with it and the pot hold $1 trillion, you're going to have a number of views on different subjects, and I think that's healthy.

I think that the people at the Department who are engaged in this process would also agree that it oftentimes takes them a very long time to do things, that in that period of time when those transactions are not yet approved, investment opportunities might be missed.

At the same time, as you indicated, their approach is one of caution because many of these class exemptions, as you pointed out before, are really almost in the nature of regulations; that is, they affect an entire class of transactions as opposed to one transaction.

The regulatory process as well takes an inordinately long time because of the various steps that it has to go through.

I think that the Department is taking a look and will be taking a further look at the issue of whether or not an SRO to address some of these problems is a good idea. We have heard, I think, very vigorous comments from some of your colleagues on the other side in the House of Representatives that they don't think the SRO's are a very good idea at all. As a matter of fact, they think it's downright illegal.

We are exploring that. The Secretary, the new Administrator, will be exploring that recommendation that an SRO be considered.

I'd like to ask Mr. Lebowitz to address the question of the exemption process.

Mr. LEBOWITZ. To some extent, as with the case of the 5500 form, the process is imposed on us by the statute. The statute requires, for example, that before an exemption can be granted by the Department, a notice of a proposed exemption has to be published in the Federal Register and an opportunity for comment on the part of interested parties has to be made available.

In some cases, at least, we have to offer the opportunity for a public hearing.

So the statute itself requires a careful and deliberative process, I think recognizing the fact that underlying it all, what we're talking about are transactions which are defined at least as having at least the potential for abuse arising out of conflicts of interest.

Senator COHEN. Jeffrey Clayton gave some very impressive testimony yesterday, which was also quite depressing in the sense that he indicated that people are just ignoring the prohibition transaction rule. They take a look at 6 months or 1 year, or whatever it might take, and say, in essence, to hell with it. We'll just go ahead. It's in the best interest of the plan, and why not just do it? The DOL will never catch up with us. They're so engulfed with paperwork and divided jurisdiction, that the chances of them ever auditing us and catching it are miniscule, and we're prepared to take the risk because we think we can show that it was for the benefit of the plan in any event.

The likelihood of us being penalized is minimal, also.

Do you agree with that assessment? It has fairly profound consequences, I think, for the whole program if that's going on.

Mr. LILLY. My view, from what I've heard from people who are in the pension community, is generally that they are doing everything possible to comply with the rules and regulations, including getting irritated and waiting in line for the exemption process to take its course.

In terms of being out there on a day-to-day basis, engaging in such transactions, I really can't comment on that because I haven't been in that situation.

Maybe Mr. Lebowitz could comment on what his experience has been.

Mr. LEBOWITZ. I would think that there are probably a substantial number of situations where people have been on the borderline in terms of their own legal analysis of whether or not the particular transaction might give rise to a prohibited transaction. And if faced with a choice of going through the exemption process that may take 5 or 6 months or longer, they may opt for a more, if they have a cooperative attorney, perhaps a broader legal opinion that might give them a little more comfort to go ahead with the transaction.

I would think, and I would hope, that there are not that many examples of people who are engaging in transactions that are on their face unlawful and that can give rise to very substantial tax and other civil penalties, particularly if those transactions are between the plan and people who are very close to the plan, such as an employer, who has virtually complete control over the assets of those plans.

That's hardly a technical violation.

Senator COHEN. Assuming that violations are occurring on a fairly widespread basis, what should be the policy of the Department of Labor, when the prohibited transaction benefited the plan? Should we, nonetheless, insist upon fines as punishment rather than a reward for the good judgment shown by the individual fiduciary?

Mr. LILLY. I think, Mr. Chairman, that we have always attempted in the enforcement—that is, every administration at the Department of Labor—has attempted in the enforcement of ERISA to not get into a situation where they say, well, that's OK. The end justifies the means.

If we took that approach, then we would have to approach every trustee's decision and say, how did it end up, rather than what did they do? Gee, these loans to the casinos in Las Vegas made them a little bit of money. That's OK that they were insider transactions. I would see that kind of a problem arising.

So I think that our view would be if people come in and say, we need a class exemption, or an individual exemption, which we need to enage in the following transaction, that the appropriate approach is to come in and tell the Department of Labor, we need to do this in 3 or 5 months, and then be faced with the bureaucratic problems and try to overcome those problems.

I recognize the burden that places on the person making the application. But I think the Department would look very unfavorably upon a process whereby the plan failed to apply for the exemption. We do not want to be in a situation where it was discovered that a prohibited transaction had taken place, but somebody suggested that we should not assess the same type of penalties we otherwise would because the result had been OK.

Senator COHEN. What about the approach recommended by Jeff Clayton? He talked about an arm's length adequate consideration standard. Should we adopt that standard in the prohibited transaction field?

Mr. LEBOWITZ. I would just note that that had been the standard prior to the enactment of ERISA and was specifically considered and rejected as essentially unworkable as any kind of effective enforcement deterrent.

Sentor COHEN. He recommended shifting the burden of proof upon the party-in-interest.

Does that change the formula?

Mr. LEBOWITZ. Speaking for myself, I'm not sure that it would make an awful lot of difference. It's still an after-the-fact kind of evaluation of what went on, even if the burden is on the fiduciary to prove that what went on was appropriate.

Mr. LILLY. And, again, I would just point out that you have the potential there, as we are facing with the entire issue of legal fees for trustees, you have the potential there for the plan and the trustees coming in to defend themselves for a transaction that may be suspect. And what are they using to fund that defense in many instances but plan assets?

And again, is that the wisest use of the plan assets? It's a difficult question.

Senator COHEN. Mr. Lilly, you've indicated to some of my colleagues on the House side that the SRO would be illegal, and that the Labor Secretary doesn't have the legal authority to create one.

Has the Department of Labor ever issued a legal opinion as to whether or not it's within the authority of the Secretary to create an SRO?

Mr. LILLY. The Solicitor's Office has drafted a legal opinion with regard to some of the issues that have arisen in the discussion of the concept of an SRO. That draft legal opinion indicates that we think that subject to certain qualifications, and further issues would have to be explored, an SRO is not something which on its face is absolutely illegal.

We think that it has possibilities. Much of it would depend on how it was structured, the members, what role they would have, and as I mentioned before, the fact that we believe that even with the possibility of some sort of an SRO, the final decision would still have to, in many instances, be made by the Department.

The example has been used oftentimes in the discussion of the SRO that something along the lines of the National Association of Securities Dealers format might be used.

I think that's an interesting discussion and an interesting example, but I would point out again, as I'm sure you're becoming aware, Mr. Chairman, the more time you spend in this area, that the ERISA industry is *sui generis*. You had testifying before you yesterday two lawyers who were former Administrators—Mr. Monks is a lawyer, but is not practicing law. You have today a banker and others, and I'm sure that there will be many people, if you continue these hearings, from insurance companies, real estate ventures, everything else, who would want to come in and testify.

The difference, I think, between something as relatively separable as the securities industry and the ERISA industry is astounding. Any time you have capital needed, somebody will want to have access to the ERISA pool of capital.

It is not like the securities industry, where you're only regulating a small group. That doesn't, in my opinion, mean that the SRO is not to be carefully explored, but it means that the concept of an SRO in the ERISA industry is a difficult one to wrestle with.

Senator COHEN. A final question. You mentioned asset reversion schemes. At one time we worried about underfunding of pension plans and now we have plans actually being overfunded in a number of cases.

There has been a trend, at least in recent days or years, toward a more active termination of plans. Questions have been raised as to whether or not a statutory change ought to be made.

Mr. Gordon, as I recall from yesterday, said perhaps we might make some changes dealing with the purpose for which a plan may be terminated. If it's being terminated in order to either defend or engage in a corporate take-over scheme, then perhaps some restrictions ought to be placed on that kind of termination.

What is your assessment?

Mr. LILLY. Mr. Chairman, this is one issue that the distinguished Senator from Ohio and I talked about at great length during my confirmation hearings, and it's been talked about at great length since.

It's a very important issue with regard to both the amount of money in these plans and the moneys that are being used for the protection of retirement income of the workers.

I think we have two counterbalancing factors here. On the one hand, you have the retirement benefits that the individuals are entitled to under the plan and ensuring that those benefits are available. Coupled with that, you have the obligation and the expectation—the obligation of the plan to provide those benefits and the expectation of the employees to those and perhaps other benefits.

That's on the one hand.

On the other hand, you have a system that has produced, at least some of the experts say, perhaps the best retirement system in the world, a voluntary system. There are dangers, potential dangers to that voluntary system not in terms of what is already there, but in terms of the new companies coming into being and in terms of the new plans that might be set up.

The danger to that system would be if changes were made in the statute which some might interpret as being changing it from a voluntary system to an involuntary system, so that once you're in, you can never get out. The result might be that companies would no longer establish pension plans.

Obviously, the question has to be addressed. There has to be careful, objective analysis and discussion of the issue, and I think that that discussion and analysis is one in which the Department of Labor would hope to participate to a significant degree.

So I think we would be willing to discuss and analyze that.

Senator COHEN. I want to commend you for your Delphic ambiguity in your response to that question. [Laughter.]

I assume the Department of Labor is going to at least take an active look at this issue.

Mr. LILLY. We have been participating so far in an active fashion in terms of writing information and I think that the new Secretary and the new Administrator will also be very deeply involved in this and the analysis of the issue.

Senator COHEN. Thank you both very much. Mr. Lilly, I may have some other questions, but in trying to anticipate the tactics that are being used on the floor, I'm going to try to rush the hearing a little bit along. I appreciate your testimony and that of Mr. Lebowitz.

Mr. LILLY. Mr. Chairman, if you would desire, we could answer those questions in writing, if you want to.

Senator COHEN. I would appreciate your being able to do that.

Mr. LILLY. Fine. Thank you very much.

Senator COHEN. Thank you.

[Mr. Lilly's prepared statement follows:]

STATEMENT OF FRANCIS X. LILLY
SOLICITOR OF LABOR
BEFORE THE SUBCOMMITTEE ON OVERSIGHT
OF GOVERNMENT MANAGEMENT
COMMITTEE ON GOVERNMENTAL AFFAIRS
UNITED STATES SENATE

June 26, 1985

Mr. Chairman and Members of the Subcommittee:

I am pleased to be here today to discuss the Department of Labor's implementation of its responsibilities under the Employee Retirement Income Security Act of 1974 (ERISA). Accompanying me is Alan D. Lebowitz, the Acting Administrator of the Office of Pension and Welfare Benefit Programs (OPWBP).

At the outset, let me state that Secretary Brock has asked me to express to you his deep commitment to the pension program. He has stated many times that this program is one of his top priorities, and that he intends to devote a great deal of time and energy to it. To emphasize the importance of this program, the Secretary intends to elevate the position of Administrator of the Office of Pension and Welfare Benefit Programs to the rank of Assistant Secretary. He is hopeful that an individual to fill that position will be on board before the August recess. Secretary Brock will work closely with the new Assistant Secretary to examine and evaluate all matters relating to the Department's role in ERISA. Secretary Brock's commitment to the program is firm, and he looks forward to working with you, Mr. Chairman, the Members of the House and Senate Labor Committees, and all other interested committees in both the Senate and House of Representatives, on retirement income issues.

One need only look at the numbers to understand the importance of the ERISA statute. There are presently approximately 65 million workers participating in 785,000 private pension plans in this country. These plans have assets of approximately $1 trillion, and it has been estimated that this figure will increase to approximately $2.2 trillion by the year 2000 (in 1984 dollars). The purpose of ERISA is to protect these millions of workers and trillions of dollars from the abuses that had historically plagued the pension benefit world and to enhance the retirement incomes of American workers. There can be no doubt that due to the enactment of ERISA by Congress, and the administration and enforcement of ERISA by all involved agencies, our pension system is on much firmer ground today, than it was only a short eleven years ago. A system is in place that, although not perfect, provides valuable protections for these people and their pension assets.

Out of necessity, ERISA is a highly technical and complex statute. In addition to this Department's responsibilities under ERISA, certain other responsibilities have been assigned to other agencies. The Internal Revenue Service has primary responsibility for administering the tax provisions of ERISA, and for matters relating to the participation, vesting, and funding standards. The Pension Benefit Guaranty Corporation is responsible for administering the detailed provisions of Title IV of ERISA governing the terminations of defined benefit pension plans and for ensuring the benefits of participants in such plans. We also coordinate a variety of matters with the Department of Justice. Close coordination among all these agencies is essential because of the many common definitions and common concerns. Furthermore, ERISA affects numerous industries, including securities, insurance, investment banking, and real estate, which have traditionally not been within the sphere of responsibility of the Department of Labor.

Because of the magnitude of the universe affected by ERISA, it is imperative for the Department to constantly review and assess what we have accomplished in the past, and to determine what needs to be done in the future. We have recently engaged in such a process both internally and in other forums, such as the National Pension Forum. I will discuss the results of these reviews in more detail later in the testimony.

In addition to our own reviews, our activities have been reviewed by others as well. For example, on numerous occasions, we have been the subject of oversight hearings, such as today's, and we have received valuable insights from these experiences. Our eleven years of experience in administering ERISA has provided us with a better perspective on how broad the original ERISA mandate was, and the resources needed to fully accomplish that mandate. We welcome and appreciate the interest, assistance, and recommendations of this subcommittee, the Permanent Subcommittee on Investigations, the Senate Labor and Human Resources

Committee, and all the other congressional committees which have jurisdiction over the statute.

When ERISA was enacted, it was designed, in large part, to address two major and extremely serious problems found to exist in the employee benefit plan world. The first was the loss by employees of all individual pension benefits despite many years of employment. Congress addressed this concern by providing for minimum participation, vesting, and funding standards, and by establishing a program to ensure the benefits of participants of plans that were terminated. The second was the need to protect the integrity of the assets of the plans. Provisions were enacted establishing strict standards governing the conduct of plan fiduciaries and the government was given the statutory tools to enforce these standards.

After the enactment of ERISA in 1974, it was necessary to shape the statute's goals into the practical reality of a program to implement these goals. Much of the first six years of ERISA was spent by the Labor Department, the Internal Revenue Service, and the other agencies involved in interpreting the statutory language and the legislative history, and in coordinating their respective roles. A great deal of OPWBP's resources and energies was devoted to activities which would help define the law and establish precedents.

When this Administration took office, former Secretary Donovan pledged that the enforcement of ERISA was to be given high priority and high visibility within the Department. As part of that effort, and under the leadership of among others, former Administrator Robert A.G. Monks, OPWBP engaged in the process of internal review and reorganization in order to enhance the Department's administration of its responsibilities under ERISA. I would like to briefly mention two such recent reviews.

In 1984, a special ERISA Enforcement Task Force was established by the Secretary to review all aspects of the Department's enforcement responsibilities under ERISA. The Task Force was composed of the OPWPB Administrator, the Solicitor, and the Inspector General. The Administrator of OPWBP, in turn, established a Working Group co-chaired by himself and the Deputy Inspector General. This group concluded that, despite many notable successes in the past, the Department's ERISA enforcement activities lack sufficient credibility both in the employee benefit plan world and in the executive and legislative branches of the Federal government.

The Task Force concluded that this problem was primarily the result of a lack of sufficient resources to effectively establish credibility as well as less than optimum use of the resources which had been allocated. The Task Force's report, which has been delivered to the Secretary's office and is awaiting his and the new Administrator's review, suggests improvements which, in its view, are necessary to provide the Department of Labor with a credible overall ERISA enforcement program.

In addition, in 1984, on the tenth anniversary of ERISA, former Secretary Donovan convened the National Pension Forum, a group comprised of the statutory ERISA Advisory Council, members of both Houses of Congress, and representatives from the Department of the Treasury, the Office of Management and Budget, the Council of Economic Advisors, and the Pension Benefit Guaranty Corporation. The Secretary instructed the Forum to propose administrative and legislative recommendations to improve the Department's ability to fulfill its statutory responsibilities under Title I of ERISA.

The Forum recently completed its work and has submitted its findings to the Secretary's office. The Forum recommended, among other things: (1) the computerization of the ERISA information management system; (2) that the Secretary extend to OPWBP the necessary hiring authority to permit the hiring of lawyers in the pension program at the investigative level; (3) that the Department explore the concept of a self-regulatory organization (SRO); (4) that the Secretary create an Office of Pension Statistics; (5) that the Secretary designate the principal officer of OPWBP as an Assistant Secretary; and (6) that the Secretary continue to devote resources for public outreach and assistance. As I will note, the Department is currently in the process of implementing some of these recommendations. The other recommendations will be reviewed by the Secretary and the new Administrator.

As these reports make clear, a great deal more work is required. We recognize this fact and are determined to continue our efforts to improve our administration of ERISA. We are rightfully proud, however, of our efforts to date. I would like to summarize some of those efforts and accomplishments.

One especially significant result of our internal reviews has been the reorganization of the Office of Pension and Welfare Benefit Programs. Upon the passage of ERISA in 1974, the Secretary of Labor's responsibilities were, for the most part, delegated to the Labor-Management Services Administration. In January 1984, the Secretary signed an order making the Office of Pension and Welfare Benefit Programs an independent agency within the Department of Labor with the Administrator reporting directly to the Secretary.

A new Division of Investigations was established within the national office of OPWBP to undertake investigative activities in certain areas, including nationwide, high visibility, and/or precedent-setting civil and criminal investigations. Specialized areas handled by the Division of Investigations cover leveraged buyouts involving employee stock ownership plans, corporate takeovers where plan assets are used, large scale criminal investigations, investigation of health and welfare fund programs which have a national impact, and investigations of investment advisors and broker dealers which are on a national scale.

In order to eliminate overhead and to utilize resources more directly, OPWBP's field offices have been consolidated into ten area offices and five district offices. These area offices for the first time report directly to the OPWBP national office. The new structure of OPWBP allows enforcement policy to be implemented in a more direct and efficient manner by offices whose sole responsibility is the effective enforcement of ERISA.

The Office of Pension and Welfare Benefit Programs has the awesome responsibility of protecting the wide universe of plans. Pursuant to the Department's statutory obligations, OPWBP conducts investigations, handles applications for exemptions, processes reports, conducts research, and handles public inquiries.

OPWBP's program of investigations is designed to identify and correct violations of ERISA, as well as to serve as a deterrent against abusive practices. Greatest emphasis is placed on fiduciary investigations, but OPWBP also performs limited plan audits, conducts reviews of compliance with bonding and reporting requirements, and investigates criminal violations of ERISA and related laws. Criminal investigations conducted by OPWBP resulted in ten indictments this year. With civil violations, OPWBP usually seeks appropriate remedies through voluntary compliance, and has also been active in civil litigation where voluntary compliance cannot be obtained or is not appropriate. In Fiscal Year 1984, the Secretary recovered plan assets and set aside prohibited transactions involving $93 million, an especially high amount due to the completion by settlement or judgment of four large cases involving about $30 million. We have supplied your staff with a list of these cases and the amount of recovery in each case.

ERISA, and comparable provisions of the Internal Revenue Code, specifically prohibit a plan from dealing with certain insiders, known as "parties in interest," unless the transaction is exempt. If no existing statutory or class exemption exists for the transaction, the parties may apply for an individual exemption.

As originally enacted in ERISA, the processing of all exemption applications involving prohibited transactions under § 406 rules was conducted jointly by the IRS and the Department. From the effective date of the fiduciary provisions through December 31, 1978, these agencies received 1,148 applications for exemptions and closed 609. Because of the delays in processing these applications, public and congressional concern mounted as to the feasibility of the administrative exemption procedure.

In an effort to expedite exemption processing, Reorganization Plan No. 4 of 1978 transferred authority to issue exemptions, for most cases, from the Secretary of the Treasury to the Secretary of Labor. As a result of the reorganization and the grant of precedential exemptions covering typical transactions between plans and parties in interest, the Department has greatly increased the number of individual exemptions closed to over 900 per year, while reducing the average case processing time for both approvals and denials to under 5 months per application.

The dynamic growth of new financial instruments, however, guarantees continuing pressure on the Department for the timely issuance of these exemptions. For example, deregulation of the banking industry, and the development of sophisticated vehicles for investment in real estate, insurance contracts, and securities, have prompted the submission of exemption applications that present novel policy and legal issues. Some of the cases involving such major issues as shared investing between plans and fiduciaries, the establishment of performance compensation arrangements, and particular requests for retroactive relief, have encountered delays. Although these issues are very complex, these matters are proceeding steadily toward resolution.

Consistent with budgetary constraints, we have carefully recruited personnel so as to enhance the professionalism of the exemption division and its ability to keep pace with its increasingly complex inventory. As was recommended by the National Pension Forum, the Department is currently working toward delegating Schedule A hiring authority to OPWBP in order to permit the hiring of attorneys in the program.

Congress also authorized the Secretary of Labor to promulgate exemptions for classes of transactions, each of which affects broad economic areas, where appropriate findings assure the protection of participants and beneficiaries.

Since ERISA's enactment, numerous class exemptions have been issued. For example, the qualified professional asset managers class exemption provides broad relief for a wide variety of transactions, where an employee benefit plan's assets are turned over to qualified professional asset managers. Similarly, relief has been provided for investments in common or collective trusts and pooled separate accounts maintained by banks and insurance companies, respectively.

In the regulatory area, the Department has promulgated over 50 regulations which provide guidance to the employee benefit community. For example, despite its importance to the ERISA enforcement scheme, nowhere in the law is the term "plan assets" defined. The issue is important because a person who engages in certain activities with respect to the assets of a plan is considered to be a fiduciary of the plan, and therefore is subject to all of the fiduciary obligations and prohibited transactions provisions of the Act, as well as extensive reporting requirements. The Department has published a proposed regulation on the "plan assets" subject, and hearings were held in May. Extensive comments on this regulation were received and they will be reviewed and assessed.

ERISA also imposes detailed requirements on plan sponsors to file annual reports, to prepare plan descriptions, and to file and distribute summary plan descriptions. The design, distribution, technical assistance, receipt, and processing of these required reports require OPWBP to allocate a significant share of its total resources for the purpose of the management of this data base.

The major ERISA report is the Annual Report series (Form 5500). This is a financial statement of the plan's condition and annual financial activities. Approximately 960,000 plans will submit the 1984 Form 5500 series report, including the shorter forms filed by small plans. About 100,000 plans submit the full Form 5500 which averages 12 pages in length and contains detailed answers regarding the plans's financial status for the past year. At this time, OPWBP maintains over 5 million annual reports in its files.

In addition to the Annual Report series, OPWBP receives several other reports from plan sponsors. ERISA requires each covered plan to submit a written narrative entitled a Summary Plan Description. These reports are submitted on a ten year cycle but amendments must be submitted when a plan is changed in a material fashion. OPWBP currently maintains approximately one million Summary Plan Descriptions. Master trusts, top hat, common collective trusts, and apprenticeship plans add another 4,000 reports per year received by OPWBP. Also, OPWBP responds to approximately 1,000 telephone inquiries annually from filers who need technical assistance with the reports.

Much of the information contained in these required submissions is essential to the work of OPWBP. Reliable and timely information is required to carry out the agency's statutory responsibilities of policy formulation, enforcement, and public information. OPWBP has completed a pilot project to demonstrate the feasibility of the electronic submission of ERISA data. If this project is found to be successful, the Secretary may investigate ways to obtain further funding for electronic filing.

The Department is authorized under section 513 of ERISA to undertake pension research and surveys, and to collect, compile, analyze, and publish data and statistics relating to employee benefit plans. The Department has attempted to function as the central clearinghouse within the Federal government for all research and statistical collection efforts dealing with ERISA. We recognize the need to closely study the impact of pension funds on the economy and the role of private pensions in providing economic security to retired workers, in order to understand and anticipate developments as they affect pension policy and to make appropriate recommendations and policy initiatives.

Despite the fact that the resources of the research program have fluctuated over the years, much significant research has been completed. A major study, entitled Pension Economics, was completed in February 1985. This study, which assembled available pension data and economic research on pensions, addressed the development of the pension asset base, its potential for further growth, and its implications for labor and capital markets in the future.

In 1984, OPWBP began a major project to develop, maintain, and analyze Form 5500 series data. This is a continuing project to establish and maintain a historical data base of a large sample of Form 5500 series reports. The data entry and editing of a large sample of the 1981 and 1982 filings is expected to be completed under contract during Fiscal Year 1985.

Another example of research undertaken is a detailed report analyzing the benefits currently paid to retirees and beneficiaries. This report used data from the Social Security Administration and results of an OPWBP contracted survey to estimate total retirement income and wage replacement. A number of characteristics of retirees is available, including earnings, type of retirement, age, sex, race, and years of service. Also, a project to accumulate and analyze data regarding rates of return on plan investments is scheduled to be completed by the middle of 1986.

In addition, in January of this year, OPWBP conducted hearings focused specifically on the issues of pension investment performance and corporate governance. Those giving testimony came from both the academic and business sectors and included some of the foremost authorities available. The hearings brought forth a variety of conflicting views and suggestions as to the issues examined in the two fields and provided a valuable record for future reference.+STUDY

OPWBP also conducts a program, initiated in March 1980, which provides assistance to plan participants and beneficiaries in securing benefits to which they are entitled but have been unable to obtain from plan sponsors. Through this program, OPWBP has helped to obtain benefits for participants and beneficiaries in an amount of about $12 million.

Along with these significant reforms and developments in the Department's administration of ERISA, we, in the Office of the Solicitor, have pursued and brought to successful completion a number of important enforcement cases. As a result of our litigation efforts, we have obtained notable results, including numerous judgments restoring large amounts of money to pension plans, injunctions to prevent illegal transactions from continuing, removal of breaching fiduciaries, and remedies which seek to prevent future abuses from occurring.

In addition, our suits have successfully established important legal principles which will protect participants and provide guidance to fiduciaries attempting to comply with their duties. These principles involve, for example, the duties of fiduciaries in considering whether to make a variety of investments such as loans, real estate investments, and insurance purchases; the factors which should be considered when plans purchase closely-held securities issued by the plans' sponsoring companies; and the liability of non-fiduciaries who knowingly induce fiduciaries to breach their duties.

We are especially proud of the advancements made, through the cooperation and efforts of all the government agencies involved, in the Government's long-standing litigation involving the Teamsters' Central States Pension and Health and Welfare Funds with their approximately 500,000 participants and beneficiaries. On September 22, 1982, the Federal district court in Chicago entered a far-reaching consent decree containing all of the safeguards over the Pension Fund's administration that the government had been seeking for over seven years. The decree:

-- Requires that the Pension Fund operate in full compliance with ERISA and with any conditions contained in determination letters issued by the Internal Revenue Service.

-- Requires a named fiduciary with exclusive responsibility to manage and control Pension Fund assets. The named fiduciary must be among the 25 largest banks, insurance companies, or investment advisers in the United States and receive court approval. Morgan Stanley, Inc. currently serves in this capacity.

-- Places strict controls on moneys used by the trustees to pay the Pension Fund's benefits and administrative expenses.

-- Provides for the court appointment of an Independent Special Counsel to examine the activities of the Pension Fund and to oversee and report regularly on the Fund's compliance with ERISA and the consent decree's requirements. Former U.S. Senator and Attorney General William B. Saxbe presently serves in this capacity.

On February 14, 1985, as a result of the court's entry of a separate consent decree, virtually identical safeguards were extended to the Health and Welfare Fund. On the same date, the court entered a related consent decree that required payment to the Health and Welfare Fund of $6.4 million to settle the Department's claims against defendants associated with the late Allen M. Dorfman. This brought our recoveries in the Teamsters' Central States cases--actual dollars returned to the Funds to pay benefits to their participatants and beneficiaries--to more than $17.5 million.

The Department has enjoyed similar success in the litigation arising involving loans made by the Southern Nevada Culinary and Bartenders Pension Trust to companies controlled by Morris A. Shenker. Pursuant to a January 1983 consent decree with certain trustees of the Pension Trust, we obtained $3.7 million in restitution to it, as well as safeguards for its future operation comparable to those in the Teamsters' Central States cases. Later, following a six-month jury trial in Las Vegas, the Federal court entered a judgment against Shenker and his companies on May 15, 1984, and ordered restitution to the Pension Trust of approximately $36.5 million.

I would also note that we have devoted considerable time and energy of late to a different type of case which has resulted from the charged atmosphere on Wall Street surrounding the escalating number of corporate takeover attempts and mergers. In our leading case, Brock

v. Bierwirth, we are continuing to litigate over the propriety of actions taken by the trustees of the Grumman Corporation pension plan to assist Grumman in opposing a hostile takeover attempt by the LTV Corporation. In two other cases, we have successfully established the principle that pension plan assets cannot be used to promote takeover attempts by the plan's sponsoring company. In addition, we are continuing to examine the increasingly frequent practice of involving employee stock ownership plans (ESOPs) or similar arrangements in leveraged buyouts usually designed to avoid takeover threats. In two notable situations involving buyouts of large publicly held corporations, Raymond International Inc. and Blue Bell, Inc., we have issued enforcement letters which set forth our views on the duties of plan fiduciaries and resulted in significant improvements in the plans' investments.

Mr. Chairman, these are our achievements in the implementation of ERISA. I would especially note the contributions made by the three former Administrators who appeared before you yesterday. Their jobs were difficult, indeed, and I am sure seemed thankless at times. Their efforts resulted in greater security for plan participants and beneficiaries.

I am sure that the Subcommittee appreciates the fact that the issues the Department faces under ERISA are many, varied, and increasingly complex. We are determined, however, to enforce ERISA in a fair and objective manner, and we are determined that the essential rights of participants and beneficiaries will be protected. In conclusion, I would like to reiterate Secretary Brock's deep commitment to the pension program. Under his leadership, we will discharge our obligations and responsibilities under ERISA vigorously.

I would like to thank you again for allowing us this opportunity to appear before you today. We would be pleased to answer any questions you might have.

Senator Cohen. I'm pleased to welcome as our next witness, Dean LeBaron. Mr. LeBaron is the president of Batterymarch Financial Management, one of the Nation's largest investment management firms.

Mr. LeBaron, welcome. Your name has been invoked several times during the last few days.

TESTIMONY OF DEAN LeBARON, PRESIDENT, BATTERYMARCH FINANCIAL MANAGEMENT

Mr. LeBaron. I heard that with shivers. [Laughter.]

Mr. Chairman, I see that your normal procedure is to read the prepared testimony, and in deference to government, I should probably do that. But in deference to the time, if I may, with your permission, let me skip your normal procedure. You can read much faster than even I can speak, and I can go at a fair clip.

So let me try to summarize my views and then make myself available to you for your dissection—live dissection, I hope, but that we'll see in time.

Senator Cohen. Your full statement will be included in the record.

Mr. LeBaron. Thank you very much, Mr. Chairman.

When I listen to some of the discussion that goes on in the corporate governance area, I'm baffled, because it really sounds so terribly, terribly complicated. And perhaps I spend so much time with computers that I'm more digital and sort of on and off ones and zeros, that issues like conflicts of interest or long term versus short term or R&D being good for the economy or not, or preservation of employment, or rewards or tenure for management, strike me as remarkably simple and not terribly complex. I perhaps get confused by the jargon.

Let me try to expose why I think that is sufficiently simple.

First is general clarity, I think, and agreement on all sides of the issue that ERISA is for the sole benefit of beneficiaries. We all speak for them, but somehow, by speaking for them, we disagree and sometimes come to great clashes. But at least we've got one point from which we can start.

Second, professional management, agents, and so forth, like me and others, seem to be desired and it does seem to be a field which meets some sort of a need by sponsors and beneficiaries. This is a growing area of having people like me as intermediaries dealing for this large body of beneficiaries who want nothing more than the assurance of an adequate living standard at some indefinite and uncertain time in the future.

Third, we all seem to be agreed that free markets, however we define that, and I think that's also fairly easy, are better than planned markets. And we espouse the free market, even though we may disagree.

The report that I had some measure and help from others to draft by the SEC Advisory Committee on Tender Offers several years ago espoused the free markets, and then we proceeded to disagree on most things thereafter.

Fourth, our existing equity markets in this country strike me as remarkably like a closed-end fund. A closed-end fund, you well know, is a fund which is issued to buy publicly traded assets and then, by tradition, tends to sell at an inexplicable discount from the value of those assets.

There is on the part of academics only one course that is appropriate for shareholders of a closed-end fund, and that is to make it open. All other courses are wrong.

And, similarly, I think the same is true for our own equity market. It does currently trade at less than the equivalent value of the underlying assets, so it is also like a closed-end fund selling at a discount. So there must be some evidence—there is some evidence—of trading barriers; otherwise, that discount would not exist.

And academics have been filling their journals in the past several years explaining to us what that discount or controlled premium was caused by. But they're all in agreement that it is there.

Anti-take-over charter amendments are agreed to by all academics in studies at least that I'm aware of to at least be negative on stock prices or, at the very best, uncertain or neutral.

I haven't yet read the study that says they are helpful. And, yet, some people seem to be voting for them.

The solutions to, I think, this combination of rather simple statements is also fairly easy as the statements are themselves.

No. 1, as you alluded earlier in the course of Mr. Lilly's testimony, I've become a fan of disclosure and probably have carried it to a ridiculous degree myself. But I think sunshine of all things is an extremely useful activity and disclosure of voting patterns or disclosure of almost anything, I think, will allow a free market to find its own appropriate level, without being dictated to by any particular segment or policy group.

And, finally, I have been identified with a specific proposal that carries the theme of unbundling of equity interest by encouraging whatever Government agencies may be involved to allow or promote the unbundling of the corporate power or proxy votes from the underlying financial interest of securities, and to convert proxy votes which appear to have some value, since so many people seem to be talking about it, to convert that into a market instrument that people like me have some greater degree of understanding than we do these seemingly fuzzy issues of corporate governance.

I think with the interest of promotion of disclosure in sunshine and the establishment of a new market for corporate power, separate from equity interests, most of the problems that seem imponderables today will disappear.

Thank you very much, Mr. Chairman.

Senator COHEN. Thank you, Mr. LeBaron.

If I could follow up on your statement about sunshine, Mr. Lilly, who is still with us, indicated that he would perhaps favor a disclosure policy such as you have adopted, except in those cases where it might be adverse to the interests of the investment itself. Have you come across situations where disclosure has had a negative or might have a negative impact upon the value——

Mr. LEBARON. I think that I would agree with Mr. Lilly's view because there would be no exceptions. I can't imagine the condition under which such disclosure would be harmful.

At least if it is, and since we think we're pursuing a policy which enhances the value of our shareholder assets, and we have been disclosing votes for sometime, we're probably in violation, then, of our policy by hurting the plan assets by disclosing.

I obviously don't believe that does so.

Senator COHEN. In your prepared statement, you discuss the maximization of profit motive. Do you support the view that the ERISA fiduciaries, in the context of any corporate take-over battle, have a legal duty to accept the highest bid for the stock held by the pension funds?

In other words, to take whatever gives the beneficiaries the highest immediate return?

Mr. LEBARON. Whatever it may be. I also suggested in my prepared statement that if we polled the beneficiaries and we found a magical way to ask them, the beneficiaries, which would they rather have us do—give a quiz to the motives of potential purchasers or to just go and take the highest price, thereby increasing the likelihood that they'll get the benefits that they've been promised—I'm assuming, and it's purely a hypothetical, I'm not in the polling business, that they will tell us to take the highest value.

So to the degree to which, yes, we're operating for the benefit of beneficiaries, I think that's the way they would vote and we go accordingly.

So our free markets operate on the basis that whoever is likely to pay the highest price is presumed to have, and I say presumed, at least, the best use of the asset in mind.

Senator COHEN. In other words, Ted Turner taking over CBS, by way of example.

Mr. LEBARON. I'm sorry?

Senator COHEN. Ted Turner taking over CBS.

Mr. LEBARON. Well, it does not work in every particular case, but——

Senator COHEN. I'm not asking you to make a judgment based upon that.

Mr. LEBARON. But that is the assumption that is built in to establishing a market, that they better have some likelihood of a good idea.

And I suppose that, you know, we'd go along with that. Certainly in our day-to-day activities in the stock market, we do not stop and ask who on the floor is meeting us on the floor of the exchange, what are their intentions and purposes, but, rather, we go and we're required to go for whoever has the highest price.

I think a tender offer is absolutely identical.

Senator COHEN. Does it necessarily follow from that position that you would automatically vote against any anti-take-over measure that management might propose?

Mr. LEBARON. Yes.

Senator COHEN. That is the policy?

Mr. LEBARON. Yes, it is. Further than that, I was amused a little bit—"amused" is the wrong word—but interested in the electronic filing discussion, which is not a subject on which I have any great discussion. But I brought with me a little standard spreadsheet program which you can get at your local computer store, discount store, for $243 and run on about a $900 machine to keep track of the votes. We have voted against directors who have promoted anti-take-over charter provisions in about 40 percent of the cases this year, feeling that they are not necessarily the representatives or representing our views as institutional shareholders. It's not a difficult procedure to identify, that those are harmful and what to do about it.

Senator COHEN. You mentioned in your statement that you have some "anecdotal evidence" that the voting of shares in some cases is inconsistent with the interests of shareholders. Would you elaborate a little bit on that?

Mr. LEBARON. Well, I think it's interesting to me that anti-take-over charter provisions do seem to pass, even in companies which appear to be widely held by institutions or fiduciaries.

Looking at the record of what's passing, one has to assume from that, and I don't know of the voting patterns of any other institution other than the one that I'm involved with, but one has to assume from this that there must be some votes for those provisions, for whatever reason. I'm not aware. I have no specific circumstances in that case. But I think moving from what passes to how the votes got there is an interesting procedure.

Senator COHEN. Money managers are, I assume, under certain pressures to have access to continued information and have a better, closer working relationship.

Mr. LEBARON. I have not ducked the issue that we have clearly been party to conversations in which those issues are brought up. I sent a letter to our clients several months ago basically outlining what I thought were some of the cautionary issues that should be kept in mind if these conversations are likely to take place.

But sometimes the vigor and rigor of the procedures with which people get enthusiastic about passing these things may sort of overcome a careful assessment of what's going on.

It is reasonably clear, I think, Mr. Chairman, that in some of the more hotly contested or widely publicized cases, where egos very much get involved, that there probably are some influences, commercial influences, that are brought to bear. They haven't had much impact upon our voting patterns, but some of the votes go in ways that we find difficult to understand.

That means we've been on the losing side.

Senator COHEN. We spent sometime yesterday talking about the practice of plan sponsors delegating their voting responsibility to outside managers. Several people have suggested that perhaps this voting responsibility ought to go back to plan sponsors because of the conflict of interest faced by outside managers.

What is your assessment?

Mr. LEBARON. Well, I think, as I indicated in my prepared statement, conflicts of interest are something that I've dealt with in the investment community and had continuously, and still do today, for a long period of time. I'm not sure that they're necessarily harmful, and I think if we go into a position of greater degrees of disclosure, the conflicts of interest and problems essentialy disappear, or at least I think they'll go away to a very, very large extent.

So ducking the responsibility of voting is not necessarily, I think, demanded. On the other hand, if there are some investment managers, and I suspect there are, who would rather not vote or who duck the responsibility of voting now because of what they feel are the commercial conflicts, then I think there is a role for a separate voting activity and I have, and would expect to support that activity for some of those firms.

Senator COHEN. How typical are your policies in voting proxies and publicly disclosing your votes within the financial community?

Mr. LEBARON. It's my impression—it's not carefully documented—that it's unique.

Senator COHEN. The question has been raised as to whether or not the Labor Department ought to mandate disclosure. It seems to me that in your comments a couple of moments ago, you indicated that to the extent you have more disclosure, there is less likelihood you're going to have these conflicts of interest presenting insurmountable problems.

So disclosure does have a way of lessening or reducing that problem. I'm not sure whether your view will be shared by those who will testify next. Mr. Cowles, I think, might have a different opinion, representing the banking interest, as to whether or not there should be mandatory or voluntary disclosure.

The Investor Responsibility Research Center came out with a report recently on pension funds and corporate governance, and they suggest that the Department of Labor issue a policy statement on what it believes the ERISA fiduciaries' duties are with regard to these corporate governance issues.

Do you think that a statement should address the voting responsibilities on these corporate governance issues and fiduciary obligations? Would it in any way make sense for a policy to be articulated by the Labor Department?

Mr. LEBARON. Well, I'm in somewhat of a quandary on that because, having said at the beginning I think it's simple, I have to conclude that a policy statement has been made and does not require further elaboration.

On the other hand, any degree of emphasis that the present practice, which is leading to lessening of the corporate accountability, is probably harmful, if that sort of thing is helpful, even though specifically not necessary, I would be in favor of it.

But it should not be necessary, in my opinion.

Senator COHEN. Any thoughts, Mr. LeBaron, on the exemption process?

Mr. LEBARON. No, I'm not sufficiently familiar with it, Mr. Chairman, to comment on that.

Senator COHEN. With reference to the 5500 form, you said there is a very simple solution.

Mr. LEBARON. Well, the electronic capturing and processing of information, I'm a fan. I've listened to people talk about being inundated with paperwork and so on and I guess perhaps they are. But with the costs of dealing with those things—maybe there are more complications there than—and I'm sure there are, than as an outsider, I'm aware of.

It seems to me that it shouldn't be terribly difficult. But I'm sure that there may be technical problems that I'm just sweeping aside.

Senator COHEN. Mr. LeBaron, thank you very much for your testimony. It's been very helpful.

Mr. LeBaron. Thank you, Mr. Chairman.

[Mr. LeBaron's prepared statement follows:]

PREPARED STATEMENT OF DEAN LeBARON

Mr. Chairman, I am delighted to accept your invitation to appear before you today to discuss ERISA and corporate governance issues. Both as an investment manager responsible for approximately $10 billion of pension assets covered by ERISA and as a former chairman of the 1983 SEC Advisory Committee on Tender Offers, I believe these issues are very important to the future of the American capital markets.

ERISA is unambiguous in providing a mandate for fiduciaries, of whom I am one, to act in the sole and exclusive interest of beneficiaries. Although I have not polled each beneficiary of the plans we work for, I can imagine that they would consider their plans and interests to be best covered by a maximization of profit motive on the part of their investment managers. Other fiduciaries in the process, including pension officers, operate in ways that suggest profit motive as their idea of the appropriate mandate as well. One can test any single item like voting rights issues by the simple question "Does this add to the value of the security in question or detract from it?" We find very little deliberation is required on most of the issues that arise when faced with that question.

Batterymarch is in favor of anything which increases the liquidity of the shares it holds for pension fund beneficiaries. Correspondingly, any limitations on the sale of the security under any circumstance, to any buyer, limits the value of that security in the market place and reduces the effectiveness of the capital markets. A takeover is little different than any other offer to purchase. Shares are continuously offered in the market to the highest bidder so that the price at the margin always reflects the highest and presumably best use of the asset. We do not challenge the motives or competence of prospective purchasers of securities we sell in day-to-day transactions through our normal stock exchange process, nor do we necessarily feel that our clients want us to second-guess the outcomes in specific takeover situations. Pension funds, like any other asset, respond best in an absolutely free market climate.

I have developed an increasing respect for the value of disclosure in promoting fair, equitable, and profitable markets. Although such features with apple-pie names like "fair price amendments" seem just, they are the masquerade of anti-takeover devices and tools to increase management primacy with independent expression of owners' interest.

Conflicts of interest are an inherent part of practically all professional situations. A corollary of extensive experience is frequently troublesome potential conflicts of interest. Normally, a professional code of ethics or law or courts or all of these guard against conflicts of interest being harmful to some clientele. There are conflicts of interest present in voting on behalf of pension funds. Certainly, the fact that corporate officials also simultaneously act for shareholders and beneficiaries is a conflict which we are quite accustomed to living with. Similarly, investment managers have a duty to act as beneficiaries, but as a practical matter, report to corporate officials. As a firm that has voted against its own clients on a number of occasions this year in corporate affairs, I can assure you it does not feel comfortable to do so. But the conflicts of interest that are present are not insurmountable problems. If one firm can vote on a strict interpretation of the issues, so can others. A climate of voluntary, or perhaps even involuntary disclosure, would bring specific actions in line with the legislative mandate of ERISA. Batterymarch has made its voting patterns available publicly; in fact, we even issue a press release ten days before every vote as an expression of our own sense of responsibility that large shareholders should make their wills known to small shareholders. We have written a simple computer program to record votes. It's available for anyone who wishes to keep track of their votes on every issue of this year's proxy season. I don't know how other managers are voting except for some anecdotal evidence that votes seem to be going in ways that I find inconsistent with shareholder rights and interests.

Something needs to be done, and promptly, I believe we are all agreed. I have made a proposal that investment managers be allowed to rent their proxy power. Proxy solicitation by corporations is intense and expensive. I suggest that this proxy solicitation process be converted into a market instrument which institutional investors can measure and understand. We are in a period of security unbundling, and I suggest the unbundling of the financial and control interests of equity securities will unlock the often hidden values. I have encouraged Batterymarch clients to ask their managers about voting practices. It's my impression that this is not a widespread topic of conversation among clients and investment managers. I am convinced that a disclosure of voting practices would solve most, if not all, of the existing problems.

Finally, I do support the establishment of new firms or institutions that might advise or act on voting rights. It is so clear that the present system does not work and that we are sliding into corporate unaccountability that I've supported anything that elevates the issue to solution.

I'm happy to have had this chance to briefly summarize my views, and I'm available to respond to the Committee's comments and questions.

Senator COHEN. Our next witness is George Cowles, the senior vice president of Bankers Trust Co. He's a member of the board of directors of the Association of Private Pension and Welfare Plans.

He is testifying today on behalf of that association. Welcome, Mr. Cowles.

TESTIMONY OF GEORGE W. COWLES, SENIOR VICE PRESIDENT, BANKERS TRUST CO., ON BEHALF OF THE ASSOCIATION OF PRIVATE PENSION AND WELFARE PLANS

Mr. COWLES. Thank you, Mr. Chairman.

I am George Cowles and I thank your staff member who correctly knew how to pronounce my name. I answer to any number of variations on the theme. Obviously, it's one of those names.

As you stated, I'm a member of the board of directors of the Association of Private Pension and Welfare Plans, the APPWP, and I'm here today to testify on its behalf.

The association's membership includes over 475 large and small plan sponsors, as well as representatives of the entire range of service providers which support the private benefits system.

The benefits community is proud of the secure and financially sound benefit system that has evolved in this country since the enactment of ERISA in 1974; its continued vitality—indeed, its survival—depends on the increased economic efficiency of its delivery system and on the expansion of creative investment choices to maximize the returns on the enormous sums of money held in trust for American workers.

Your invitation asked that we address the Labor Department's administration of ERISA, particularly with respect to the reporting and disclosure requirements of the act and the prohibited transaction exemption process.

The APPWP believes that the Department's exemption and variance authority in these areas can ameliorate many of the problems and unnecessary expenses facing plans without the disruption and lengthy delays in legislative review and change.

The Department has taken some steps to reduce the reporting burdens of the statute. We believe, however, that much more can and should be done.

The APPWP recognizes that the Department has seen a succession of Administrators over the past 10 years and lengthy periods where there has been no Administrator at all. In any regulatory program, strong and consistent leadership is crucial and it is thus not difficult to understand some of the lack of progress that has plagued the Department. In addition, staff shortages and staff turnover make the effective administration of the law that much more difficult.

The Department has chosen not to take advantage of the expertise of its own advisory council, which contains knowledgeable representation from the plan sponsor, consulting, insurance, investment, and banking communities.

In our view, the Department's attitude in this respect may be shortsighted and results in a waste of valuable resources. We would urge a far more active and integral role for the advisory council as an initial step in bringing the expertise of the private sector to bear on the important issues now facing the Department.

As a threshold matter, it seems fundamental that the Department should take advantage of advances in technology which can drastically reduce plan costs and increase Government efficiency in the employee benefit area, where unnecessary costs and delays are visited not on corporate assets, but on the assets held in trust for the benefit of participants and beneficiaries. Thus, for example, we urge the Department to expedite the electronic filing of ERISA required data submissions, the 5500 series.

In addition, we would propose the following reporting reductions which can be easily accomplished through ERISA's section 110 grant of authority to the Department.

The annual report requirements provide for a detailed schedule of plan assets held for investment in addition to the summary of assets filed as part of the 5500 submission. Submission of this data is enormously burdensome and costly. In many instances, it's hundreds of pages of attachments to a relatively simple form. Yet, it provides little useful information to participants generally and is rarely, if ever, scrutinized by the Department, absent other problems which would suggest a more thorough investigation.

Accordingly, we suggest that this requirement be waived on the condition that the complete asset list be made available for inspection or copying by a participant on a reasonable basis or by the Government.

Similarly, as part of the 5500, a listing of transactions which involve 3 percent of plan assets is required. In and of itself, this reporting requirement is of minimal utility and its independent preparation and submission is more costly than its usefulness would warrant. It, too, could be maintained and made available on request of the Government or a participant.

APPWP would also urge that the elimination of the summary annual report be considered by the Department. The SAR is expensive to prepare and to mail and because of its brevity, it may often be misleading and raise questions which would be far more efficiently answered by reference to the actual documents. We, therefore, suggest that it be eliminated or that the requirement be limited to posting it in a prominent site in the workplace.

Under sections 105 and 209 of ERISA, certain reports are required to be provided to participants relating to the amounts of their accrued benefits, their nonforfeitable benefits and whether, if terminated, they have a vested benefit. To the extent possible, under the authority of section 110, these requirements should be combined.

In summary, then, we would urge the Department to use its authority more broadly and more creatively to minimize the reporting burdens on plans, thereby minimizing the possibility that plan assets will be needlessly wasted in administrative costs that provide no discernible benefit to participants and beneficiaries.

Unquestionably, the prohibited transactions provisions of ERISA serve an exemplary purpose: They provide a roadmap to plan and plan sponsor officials to avoid the misuse of plan assets. However, in attempting to cover the universe of misdeeds, the roadmap provides no clear guidance. On the contrary, it places numerous roadblocks in the way of valid and appropriate plan investments.

While the Department has made significant strides in issuing class exemptions to give more flexibility and guidance to plan officials, such as the QPAM exemption, which Mr. Lilly referred to, further broad class relief is still necessary. In addition, the timeliness of both class and individual relief is critical if the Department's exemption authority is to have any meaning whatsoever.

This is not to say that the Department's record on giving guidance promptly has not improved over the past several years, nor is it to say that the employee benefit community has always been responsible and complete in its applications to the Department so as to speed up the process.

In addition, we all need to recognize that the investment markets are not static, and exemptions which appear to solve the problem at the proposal stage quickly become outdated as new types of investments are innovated.

Granting that fact of life, however, we believe that the quality of the applications submitted to the Department has improved and that the Department has shaved several months from the process. In the last analysis, however, it simply does not move quickly enough.

As the APPWP has testified in the past, the optimum approach would be legislative, that is, the repeal of section 406(a) and the replacement of it with an arm's length fair value standard. Moreover, there is virtual unanimity in the ERISA community that the party in interest definition is overbroad and serves to invalidate even the most legitimate transactions.

At the very least, it creates such a burdensome tracking of investors and service providers that the costs of an investment or a service are ultimately inflated far beyond that which would be necessary if the standards were not so complex and difficult.

The number and variety of possible transactions that are prohibited by the ERISA rules are enormous. The vast majority would be innocently entered into in the plan participants' best interest. It is unreasonably burdensome for anyone to expect even the most diligent trustee to try to keep track of the ever-changing list of parties in interest and to review all of these relationships with respect to each and every plan transaction.

In addition, the Internal Revenue Code's excise tax for prohibited transactions is imposed with respect to even an unknowing violation of the rules by those who are simply not in a position to determine the diverse relationships which may be incident to a real estate or a venture capital transaction, for instance.

Not only is the process difficult and complicated, but, more importantly, excellent investments are bypassed because of the risk that a technical violation of the prohibited transactions provision will be unwittingly committed.

We are still awaiting regulations under section 404(c)—that is the separately invested individual account plan—which we believe would provide at least some guidance and relief for fiduciaries in the take-over context. Similarly, regulations covering ancillary bank services has yet to be proposed, as have regulations defining plan assets yet to be finalized.

Clearly more creative class exemptions are called for to exempt a wide variety of transactions which would objectively inure to the benefit of plans. Additional use of the advisory council's outside expertise would lend assistance to the Department in analyzing complex financial transactions which, because of their novelty, are initially viewed as suspect by the Department, we believe.

The plan trustee seeking to maximize investment return is the rule, not the exception. Innovative approaches designed to increase a plan's rate of return should not be cast aside simply because the Department cannot insure that they are incapable of abuse; indeed, the general standards of prudence in section 404 of ERISA might well serve to thwart any possible abuse far more effectively than the complex proscriptions in the prohibited transaction provisions.

One method of dealing with delays in the exemption process would be for the Department to create a two-step process whereby prototype individual exemptions could be used as models to approve certain categories of individual exemptions within a 90-day period. If the exemption request was incapable of fitting within these categories, the requester would be so informed and could make decisions with respect to the transaction accordingly.

The plans and, ultimately, their participants and beneficiaries are the primary victims of the inefficiencies of the regulatory body on which they are dependent for guidance. Without substantive progress on the breadth of relief available and the timeliness with which it is offered, only a legislative solution will suffice to allow plans the necessary freedom to engage in beneficial and legitimate transactions.

We in the benefits community need strong and effective administration of ERISA and we are prepared to help in any way that we can. We welcome a cooperative and productive relationship with the Department and pledge our assistance in the effort to improve the quality and timeliness of guidance from the Department.

Thank you.

Senator COHEN. Thank you very much, Mr. Cowles.

Mr. Cowles, I am unclear about what you said concerning electronic filing. Does the association recommend mandatory or voluntary electronic filing?

Mr. COWLES. I think it would be difficult to recommend mandatory electronic filing. We encourage the Department—we have been participating in the project since its inception and, clearly, it should start, I believe, as a voluntary project because there are a number of trustees and plan administrators who are dealing with relatively small plans who may or may not be dealing with a major corporate trustee who could do the filing for them electronically. So I would suggest that it probably should start as voluntary and perhaps become mandatory over time.

Senator COHEN. I think that's a valid point. Another side of that question, however, is the extent to which there are tremendous delays once the written information is filed before it gets to the Department of Labor. It might work to the advantage of those firms who do not want to file electronically to simply say, if we don't file electronically, the delay will work to our advantage.

It might be wise to follow a rule that says that those who do not file by computer might be more likely to be audited than those who do. That may be one way of dealing with that particular problem. However, I think you do have to take into account the smaller firms, at least initially, since smaller plans may not financially be able to comply.

Mr. COWLES. I suspect the rule of 80-20 would apply; that is, those plans that would comprise roughly 80 percent of the assets would be a relatively small number and they would choose to file electronically. The hundreds of thousands of very small plans which might not be in a position would represent a relatively small number of assets, but, in fact, would require the Department to continue to process a lot of paper forms.

Senator COHEN. Tell me your personal experience with the prohibited transaction rules. Can you give me specific examples of cases of lost investment opportunities?

Mr. COWLES. Mr. Chairman, I'm not an investment professional and please keep that in mind as I try to address your question.

Missed opportunities have a tendency to be not specific transactions, but classes of investment. One of the concerns with real estate investments are they're fraught with conflict of interest—I don't mean conflict of interest—potential prohibited transactions.

We, as an institution, have not had a great deal of trouble with lost investment opportunities. We have, as an institution, filed for and obtained a retroactive transactional exemption because with our eyes wide open we made an investment that was a prohibited transaction, in error, and it was discovered in an audit, and so we——

Senator COHEN. Could you explain that? You say, with your eyes wide open, you made an investment that was in error.

How does one do that?

Mr. COWLES. The case in point was—we purchased in a pension fund debt instruments issued by a corporation which owned 30 percent of the plan sponsor.

Senator COHEN. You exceeded the 10-percent rule.

Mr. COWLES. It exceeds the 10-percent rule, but it is not as great as 50 percent, which would have made it an employer security, and thereby, a nonprohibited transaction.

And, as I say, it was done with our eyes wide open because the portfolio manager involved assumed that the securities were employer securities. But it was greater than 10 and less than 50, so it was not.

Senator COHEN. How long did that process take, to obtain the retroactive exemption?

Mr. COWLES. The better part of 2 years. Now that was 3 or 4 years ago, and I'm certain that it would be processed more quickly today.

Senator COHEN. What are your views with respect to an SRO? I know that in the APPWP's comments to DOL on its proposal to establish an SRO, the association stated that "an SRO is not necessarily a panacea for a variety of ills." Unless the Department develops a necessary trust of the SRO's recommendations, it seems dubious to expect the adversarial nature of the exemption process would improve in the near future.

My question is, Do you believe that the Department of Labor unnecessarily has an adversarial attitude toward the entire exemption process?

Mr. COWLES. Mr. Chairman, with all due respect, I suspect that's the Government's job, is to be in an adversarial position. And I don't necessarily mean that to be pejorative in this instance. But in the context in which the statement was made, I believe that there is an adversarial proceeding today, perhaps not an unhealthy adversarial proceeding, which examines every facet of a potential exemption, either class or transactional. And that's probably not unhealthy.

The SRO, I personally happen to think, is an interesting idea. I think it is something that should be thoroughly explored. I think there is potential for making the exemption process considerably more efficient. And part of that comes from my belief that the involvement by the SRO, which, presumably, would contain within it—either contain within it or have access to the expertise in the private sector necessary to relatively quickly understand complex financial transactions.

Senator COHEN. With respect to the statement about the adversarial nature of the Department of Labor's process, the association also stated:

> The SRO may not eliminate the Department's concern that the exemption applications are incomplete, deliberately short of protection, and possibly even abusive of the rights of participants and beneficiaries.

Are the Department of Labor's concerns in these areas legitimate? Are the applications incomplete, deliberately short of protection, and possibly abusive of the rights of participants and beneficiaries?

Mr. COWLES. I think without doubt that was the case. I think that in recent months, perhaps as much as a year, the Department has made it clear in many circumstances, or at least two or three with which I'm familiar, that they require a more complete, more protective exemption in the application process. And I think the private sector is responding.

I do believe that in the early days, and perhaps even the teenage years, if you will, the private sector would simply throw a problem at the Department of Labor and say, design me an exemption and grant me an exemption, and the burden of making sure that all the checks and balances were there were left with the Department of Labor.

I think today it is a more cooperative process and I think that's one of the reasons, that the process, in fact, has been speeded up in recent months because the private sector, in many instances, is going forward with a much more complete exemption application.

Senator COHEN. What about the need for a single agency? What would be the association's recommendation on that issue?

Mr. COWLES. The association, if I can recall its position, believes that there is perhaps some benefit to be gained by a single entity, perhaps not single agency. To me, when somebody uses the term "single agency," you think in terms of a combination of the Internal Revenue Service, the Department of Labor, into a single pension agency. And I'm not, in my own mind, certain that that idea works. I suspect there could be some benefit in a commission-like overseeing body.

One of my concerns and one of the concerns of many of the groups that I'm associated with is the apparent lack of a coherent national retirement income policy. And if there were a commission comprised of the leadership of the various departments who are involved, and perhaps representation from the Securities and Exchange Commission and all of those governmental agencies, and the private sector, charged with developing and protecting a national retirement income policy, I think that commission then might be able to assume the role that I think most people think of as the role of a single agency—that is, an oversight role and setting policy.

Senator COHEN. A number of witnesses have testified that the Department of Labor's enforcement lacks credibility among the pension community and that it really poses no real threat or deterrent plans that might violate ERISA. Do you agree with that assessment?

Mr. COWLES. I don't think it's enforcement; I think it's the statute that keeps us in line. As a representative of what I believe to be one of the most, if not the most, responsible fiduciaries in the country, we do back-flips to be absolutely certain that we are not in violation of the law. And it is a damned burdensome job, Mr. Chairman.

I don't think it's a question of, well, we can do this because the enforcement procedure is weak and we won't get caught. It's not a question of that. I think when you're the size of Bankers Trust Co., you presume that you operate in a goldfish bowl. Our client base is typically the Fortune 500. Their attitude is the same; that is, you don't assume that you won't get caught. You don't violate the law simply because you have to assume that everything you do will be scrutinized by all governmental agencies.

Senator COHEN. You indicate that people in the business are concerned about the IRS imposing penalties. Yet, the IRS has not imposed very many penalties in relation to the number of cases that have been referred by the Department of Labor to IRS for fines or penalties. I think 123 cases were referred by DOL to the IRS and a total of 16 resulted in the imposition of an excise tax. Is that a real threat to the community, as such, or is it the public exposure that's the greater threat?

Mr. COWLES. No; I think the economic threat is of equal concern. In a large transaction, and most transactions are relatively large, a 5-percent excise tax represents a significant amount of money.

I do think that one of the problems with the excise tax is that it is mandatory and there are prohibited transactions that can take place without anybody's awareness because of the very complex list of parties in interest.

And for a major plan, there are probably hundreds of thousands of parties in interest. You can only, obviously, check so far and check, as Mr. Lebowitz said this morning, I believe, at least those closely associated with the plan. And when you get out to some of the esoteric parties in interest on the fringes, you, I guess, hope.

Senator COHEN. Do you think the Department of Labor should come up with a policy statement with respect to corporate governance issues and fiduciary responsibilities?

Mr. COWLES. I suspected that you might ask me that question, Mr. Chairman. I'm not sure I disagree with Mr. LeBaron. I have a great amount of respect for Mr. LeBaron and I've heard him and am sympathetic with his position on this.

We, as an institution, do not disclose. However, we do not make our voting record a secret. It is available for anyone who wants to ask on a specific proxy how we, in fact, did vote. We manage the conflict of interest that, in fact, does exist. It takes a great deal of management time to do it, but we do it. We think we're capable of doing it.

I'm not sure disclosure would make for necessarily more responsible corporate governance. I would suggest to you that if conflict of interest is the concern, the secret ballot, which is the backbone of democracy, or at least one of the backbones, would accomplish the same result; that is, forbid a fiduciary from disclosing to anyone how he voted, other than to the plan's sponsor, and the plan sponsor, of course, is a fiduciary as well and so he would be prohibited. And therefore, because it is secret and no one could disclose it, no one could bring pressure to bear.

Disclosure does the same thing.

Senator COHEN. I'm sure there are a lot of Members of Congress who would like to have that policy adopted for voting on the Senate floor, but it wouldn't necessarily avoid the issue of conflict of interest. [Laughter.]

I think you've already testified in regard to adopting an arms' length, adequate consideration standard. Is that the recommendation of the association?

Mr. COWLES. Yes, sir, it is. That is repeal of 406(a) and return to the arms' length fair value, which, if memory serves me right, was in the House of Representatives version of ERISA when it went to conference.

Senator COHEN. As far as voting rights being exercised by the plan sponsor, you would not support that concept?

Mr. COWLES. Frankly, I'm indifferent to it. I don't believe the plan sponsor community, in general, would feel themselves necessarily equipped to do it. It is an investment decision and they have delegated investment authority. And to ask a plan sponsor who has no investment research capability in house, presumably——

Senator COHEN. What do you think about the Wall Street rule? Are firms currently following that rule in terms of voting for management or selling the stock?

Mr. COWLES. I think the decisions are independent of each other, in the sense that if you don't agree with what management is doing, you sell the stock, because you are concerned that that will impact the price of the stock. And whether a proxy vote is coming or has just passed is a matter of indifference to the sale decision, per se.

Senator COHEN. What if you disagree with the management, but you want the asset. You want to keep your investment in that particular product or line.

Mr. Cowles. Then you have the option of holding the stock, or if there is a proxy coming up, you have the right to vote your shares in favor of a dissident slate of directors, and it's happened recently in two or three situations, whose stated purpose would be to liquidate the company and realize the higher value.

It's happened in a couple of broadcast stocks of late.

Senator Cohen. What policy do you follow with respect to voting? Do you take an immediate maximum profit or a "short-term versus long-term" view? What is the fiduciary obligation?

Mr. Cowles. We think our obligation is to maximize the rate of return for participants and beneficiaries. And in voting proxies, we have tendencies—we do not have a flat policy to vote against management with respect to super-majorities or staggered boards of directors or the other shark repellants.

We do review each one very carefully in and of itself, and there are a number of combinations of those things that are more offensive than perhaps one on its face.

But we do believe maximization of the rate of return is the primary objective and in a tender offer situation, if you're talking cash, that's one thing. If you're talking paper of questionable value, then you've got an investment research job to determine whether that, in fact, is more valuable than continuing to hold on to the security.

Senator Cohen. Mr. Cowles, thank you very much. We appreciate your coming here today to testify.

[Mr. Cowles' prepared statement follows:]

PREPARED STATEMENT OF GEORGE W. COWLES

Mr. Chairman and members of the Subcommittee, I am George W. Cowles, Senior Vice-President, Bankers Trust Company. I am a member of the Board of Directors of the Association of Private Pension and Welfare Plans ("APPWP") and I am here today to testify on its behalf. The APPWP's membership includes over 475 large and small plan sponsors, as well as representatives of the entire range of service providers which support the private benefits system: banks, insurance companies, accounting firms, actuarial firms, and benefits consulting firms. The benefits community is proud of the secure and financially sound benefits system that has evolved in this country since enactment of ERISA in 1974; its continued vitality -- indeed its survival -- depends on the increased economic efficiency of its delivery system and on the expansion of creative investment choices to maximize the returns on the enormous funds held in trust for retirement, health and welfare benefits for American workers. In our view, it is critically important to insure that the resources allocated to providing benefits be maximized and that the administrative costs of operating plans be kept to the minimum level possible in relation to the benefits provided.

The Subcommittee's invitation asked that we address the Labor Department's administration of ERISA, particularly with respect to the reporting and disclosure requirements of the Act and the prohibited transaction exemption process. We recognize that any changes we suggest should diminish the burdens associated with plan administration without threatening the ability of the Department to recognize troubled plans and without endangering either the free flow of information to participants and beneficiaries or the security of plan asset investment and growth. With that in mind, the current reporting and disclosure requirements and the restrictions under the prohibited transaction provisions offer important areas for improvement of the Department's administration of ERISA. The APPWP believes that the Department's exemption and variance authority in these areas can ameliorate many of the problems and unnecessary expenses facing plans, without the disruption and lengthy delays inherent in legislative review and change. The Department has taken some steps to reduce the reporting burdens of the statute; we believe, however, that much more can and should be done. Consequently, we strongly urge a thoughtful review of these provisions with an eye toward eliminating or reducing the current constraints which, in our view, are fundamentally inconsistent with efficient plan administration.

The APPWP recognizes that the Department has seen a succession of Administrators over the past 10 years, and lengthy periods where there has been no Administrator at all. In any new regulatory program, strong and consistent leadership is critical and it is thus not difficult to understand some of the lack of progress that has plagued the Department. In addition, staff shortages and staff turnover make the effective administration of ERISA that much more difficult. We do think, however, that Department staff have tended to be somewhat insular and suspicious of the industry they regulate and the lines of communication have often been strained. The Department has chosen not to take advantage of the expertise on its own Advisory Council, which contains knowledgeable representation from the plan sponsor, consulting, insurance, investment and banking industries. In our view, the Department's attitude in this respect may be short sighted and results in a waste of valuable resources. We would urge a far more active and integral role for the Advisory Council, as an initial step in bringing the expertise of the private sector to bear on the important issues now facing the Department.

Reporting and Disclosure

As a threshold matter, it seems fundamental that the Department should take advantage of advances in technology which can drastically reduce plan costs and increase government efficiency in the employee benefits area, where unnecessary costs and delays are visited not on corporate assets but on assets held in trust for the benefit of participants and beneficiaries. Thus, for example, we urge the Department to expedite electronic filing of ERISA required date submissions. We advance this suggestion not only as filers but also as users, with need to extract information from currently filed data without undue expense or delay. The problem of document storage and retrieval at the Department and at the Internal

Revenue Service is serious for those, including participants, who seek information about their plans. Prompt and efficient retrieval of information is critical to participants as well as plan sponsors and service providers; access to data 15 months old is misleading at best and useless at worst. Accordingly, we advocate permissive electronic filing of data, and further, a reduction of data that need be filed, limiting the list to that data truly useful to have permanently on file with the government.

In addition, we would propose the following reporting reductions which can easily be accomplished through ERISA Section 110's grant of authority to the Department. ERISA's annual report requirements provide for a detailed schedule of plan assets held for investment, in addition to the summary of plan assets filed as part of the Form 5500 submission. Submission of this data is enormously burdensome and costly; yet it provides little useful information to participants generally, and is rarely, if ever, scrutinized by the Department absent other problems which would suggest a more thorough investigation of plan asset investment. Accordingly, the APPWP suggests that the ERISA requirement under Section 103(b)(3)(C) be waived under the authority of Section 110, on the condition that the complete asset list be made available for inspection or copying by a participant on a reasonable basis.

Similarly, Section 103(b)(3)(H) requires a detailed schedule, as part of the Form 5500, listing transactions which involve 3% or more of plan assets. In and of itself, this reporting requirement is of minimal utility and its independent preparation and submission is more costly than its usefulness would warrant. It, too, could be maintained and available on request of the government or a participant. We doubt whether reporting of transactions where a threshold as low as 3% would even be helpful; moreover, it seems inconceivable that this information is so routinely helpful and important that it should be part of the already massive annual report filing requirements.

The APPWP would also urge that elimination of the Summary Annual Report be considered by the Department. The SAR is widely regarded as a document with more form than substance. It tells a participant virtually nothing of value, and serves only as a reminder that there is a plan, the details of which must be found elsewhere. At the same time, it is expensive to prepare and mail, and because of its brevity, it may often be misleading or raise questions which would be far more efficiently answered by reference to actual plan documents, the summary plan description, or the annual report itself. We therefore suggest that it be eliminated, or that the requirement be limited to posting in a prominent site in the workplace.

Under Sections 105 and 209 of ERISA, certain reports are required to be provided to participants, relating to the amounts of their accrued benefits, their nonforfeitable benefits and, whether, if terminated, they have a vested benefit. To the extent possible under the authority of Section 110, these requirements should be combined. In addition, the reporting requirements for terminated nonvested participants should be merely to advise them that they have no vested benefit under the plan and such notice should only have to be provided once. When an employee terminates service prior to becoming a participant, this same notice should be applicable as well. With respect to participants who do have vested rights under a plan, annual notice should be limited to the vested amounts (in dollar, rather than percentage terms), in order to minimize the costs inherent in preparing these benefit statements, without eliminating in any meaningful way the information received by participants.

In summary, then, acknowledging that the drafters of ERISA gave the Department extraordinarily broad powers in Sections 110 and 104(a)(3) to evaluate reporting requirements in terms of their usefulness to participants, their costs to plan sponsors, and achievement of the purposes of ERISA, we would urge the Department to use that authority more broadly and more creatively to minimize the reporting burdens on plans, thereby minimizing the possibility that plan assets will be needlessly wasted in administrative costs that provide no discernable benefit to participants and beneficiaries.

Prohibited Transactions

Unquestionably, the prohibited transactions provisions of ERISA serve an exemplary purpose: they provide a road map to plan and plan sponsor officials to avoid misuse of plan assets. However, in attempting to cover the universe of misdeeds, the road map provides no clear guidance; on the contrary, it places numerous roadblocks in the way of valid and appropriate plan investments. While the Department has made strides in issuing class exemptions to give more flexibility and guidance to plan officials, such as the QPAM exemption, further broad class relief is still necessary. In addition, the timeliness of both class and individual relief is critical if the Department's exemption authority is to have any meaning whatsoever. This is not to say that the Department's record on giving guidance promptly has not improved over the past several years, nor is it to say that the employee benefits community has always been responsible and complete in its applications to the Department so as to speed the process. In addition, we all need to recognize that the investment markets are not static, and exemptions which appear to solve the problem at the proposal stage quickly become outdated as new types of investments are innovated. Granting that fact of life, however, we believe that the quality of the applications submitted to the Department has improved and, except with respect to certain long-languishing exemptions, the Department has shaved several months from the process. In the last analysis, however, it simply does not move quickly enough.

As the APPWP has testified in the past, the optimum approach would be legislative, e.g., repealing Section 406(a) and replacing it with an arm's length standard which has been used by the Department in the past in fashioning standards for class exemptions. Moreover, there is virtual unanimity in the

ERISA community that the party in interest definition is overbroad, and serves to invalidate even the most legitimate transactions. At the very least, it creates such a burdensome tracking of investors and service providers that the costs of an investment or a service are ultimately inflated far beyond that which would be necessary if the standards were not so complex and difficult. The number and variety of possible transactions that are prohibited are enormous and the vast majority would be innocently entered into in the plan participants' best interest. It is unreasonably burdensome for anyone to expect even the most diligent trustee to try to keep track of the ever-changing list of parties in interest and to review all of these relationships with respect to each and every plan transaction. Implementation of the needed procedures to review and track those relationships is expensive and time consuming and serves no productive purpose other than to avoid a violation of these provisions. In addition, the Internal Revenue Code's excise tax for prohibited transactions is imposed with respect to even an unknowing violation of the rules by those who are simply not in a position to determine the diverse relationships which may be incident to a real estate or venture capital transaction. Because of these legal complexities and the penalties for violation, the job of hiring individuals to provide services and investing plan assets has become a labyrinth which most knowledgeable and competent trustees would prefer to avoid. Not only is the process difficult and complicated but, more importantly, valuable talent is lost to the plan, and excellent investments are bypassed because of the risk that a technical violation of the prohibited transaction provisions will be unwittingly committed.

Clearly, more creative class exemptions are called for, possibly combining the use of an arm's length standard and an independent fiduciary with established credentials, to exempt a wide variety of transactions which would objectively inure to the benefit of plans. Additional use of the Advisory Council's outside expertise would lend assistance to the Department in analyzing securities or real estate transactions which, because of their novelty, are initially viewed as suspect by the Department.

The plan trustee seeking to maximize investment return is the rule, not the exception. Innovative approaches designed to increase a plan's rate of return should not be cast aside simply because the Department cannot insure that they are incapable of abuse; indeed, the general standards of prudence in Section 404 might well serve to thwart any possible abuse far more effectively than the complex proscriptions in the prohibited transaction provisions.

We point out that the confusion and uncertainty engendered by lengthy delays is not only frustrating as a matter of ongoing plan management but often results in the loss of investment opportunities which can never be replaced. The overall result is that the exemption process is generally regarded as ineffective. It becomes far preferable to invest in a lower yielding, less innovative product than to wait for relief from the Department in order to take advantage of a better rate of return on a less ordinary opportunity. One method of dealing with these delays is to create a two-step process, whereby prototype individual exemptions could be used as models to approve certain categories of individual exemptions within a 90-day period. If the exemption request is incapable of fitting within these categories, the requestor would be so informed and could make decisions with respect to the transaction accordingly. While the Association recognizes the problems of staffing inadequacies, some effort must be made to resolve, rather than continually to reiterate these problems; plans and, ultimately, their participants and beneficiaries are the primary victims of the inefficiencies of a regulatory body on which they are dependent for guidance. Without substantive progress on the breadth of relief available and the timeliness with which it is offered, only a legislative solution will suffice to allow plans the necessary freedom to engage in beneficial and legitimate transactions.

We in the benefits community need strong and effective administration of ERISA and we are prepared to help in any way we can. We welcome a cooperative and productive relationship with the Department and pledge our assistance in the effort to improve the quality and timeliness of guidance from the Department.

Senator COHEN. Our final witness today is James Heard, the deputy director of the Investor Responsibility Research Center, and director of the center's Corporate Governance Service. Accompanying Mr. Heard is Hillel Gray, the senior research analyst at the center.

TESTIMONY OF JAMES E. HEARD, DEPUTY DIRECTOR, INVESTOR RESPONSIBILITY RESEARCH CENTER, INC., ACCOMPANIED BY HILLEL GRAY, SENIOR RESEARCH ANALYST

Mr. HEARD. Thank you, Mr. Chairman.

We have a statement which we'd like to submit for the record. I think what I'll do is summarize the statement, if I could, and then we'll be available for your questions.

Let me first say a word about our organization. We are a not-for-profit corporation established in 1972 to provide research analysis to institutional investors on a variety of policy issues.

We currently have about 200 clients, including universities, foundations, bank trust departments, insurance companies, investment firms, public pension funds, and other organizations. Among our clients are some of the largest pension fund managers in the country.

The focus of our testimony today is on the role that institutional investors, and pension funds in particular, play in the corporate governance process.

As I'm sure you are aware, many institutions traditionally have followed in voting what is known as the Wall Street rule—supporting management or selling their shares. There's been a movement away from the Wall Street rule, I'd say for 10 or 12 years. The enactment of ERISA is one reason for that. The very large size of pension fund assets is another. It's much more difficult today, for example, for an institution to walk away from investments when the size of the investment is very large or when the issue of concern, such as corporations adopting shark repellants to their charters, is being undertaken on a very wide scale. You can't sell everything. You've got to stay and make some decisions based on the merits of what's being presented to you.

As I'm sure you've heard today and yesterday, the voting of proxies on corporate governance issues, and the positions of financial intermediaries in contests for corporate control, create potential conflicts of interest for investment managers. These are not uncommon for investment managers who must observe ERISA's fiduciary requirements, and who also wish to cultivate good relations with existing and potential clients.

In addition to their responsibilities as fund managers, many banks and insurance companies have other relationships with corporations that create opportunities for conflicts of interest. Banks, for example, may serve as commercial lenders to, and insurance companies may be insurance underwriters for, companies whose pension funds they manage.

Personal relationships among senior executives, including service on boards of directors of major customers, may introduce additional complications.

The appearance in proxy statements of anti-take-over charter amendments and other items that may diminish the rights of shareholders or affect the value of their investments puts investment managers in a position where they may be required to choose between their fiduciary responsibilities and their own financial interest.

Testimony given at the Labor Department's corporate governance hearings in early 1985 suggests that some pension fund managers are puting other considerations ahead of the best interest of pension fund participants.

The hearings also produced some evidence that corporations have exerted pressures on investment managers to support actions that may be contrary to the best interest of the pension fund participants.

I would reiterate here, Mr. Chairman, something that Dean LeBaron said—there is nothing in the academic literature, at least nothing that we're aware of, which indicates that anti-take-over charter amendments are beneficial to shareholders. Some of the evidence is inconclusive. But there is other evidence that suggests that these proposals are contrary to the interests of shareholders.

Senator COHEN. What does your research show with respect to the success of anti-take-over measures? My understanding is that in the overall majority of cases, the anti-take-over measures are passing.

Mr. HEARD. They are passing. We have voting results for more than 300 anti-take-over charter amendments so far this year at more than 150 major companies. There are probably not more than 15 that have failed to pass.

Senator COHEN. In view of the size of pension funds and what they comprise in terms of the investment in the major corporations, what does that say in about of how pension funds are being voted?

Mr. HEARD. If you look at the way the votes break down, you'll see that there are noteworthy levels of opposition at some companies. It's not unusual to see 20 or 25 percent of the outstanding shares voted against a proposal or abstaining. And in most instances, an abstention has the same effect as a no vote.

That would tell you that there is some significant opposition amongst institutional investors. Proxy solicitors will tell you that individual investors tend to be much more loyal to management than institutions and tend to be much more willing to follow management's recommendations.

On the other hand, as Mr. LeBaron said earlier, there are many major corporations that are 50 percent or more owned by institutions. So I think the evidence also tells you that quite a number of institutions are voting for these proposals.

Now it may be that some institutions have come to a very good faith conclusion that the proposals serve the best interest of beneficial owners. On the other hand, when you see institutions that are voting wholesale in favor of anti-take-over charter amendments, that I think tells you that they are not examining the issues on the merits.

We have been told in a number of instances that some institutions have changed their policies within the last 18 months or so, as a result of what seemed to be much heavier pressures to vote for anti-take-over charter amendments. They have changed their policies from one of either opposition or independent analysis to one in which there is across-the-board support for these kinds of proposals. I think it's hard to square that kind of practice with the notion that fiduciary is bound under ERISA to act solely in the interest of the pension fund——

Senator COHEN. What's your recommendation with respect to the so-called LeBaron rule? [Laughter.]

Mr. HEARD. The LeBaron rule of voting against them?

Senator COHEN. Yes, I think that he articulated two different rules today. The other is the general policy of making public the policy of his firm for voting and the specific votes at least 10 days in advance of the vote being cast.

Mr. HEARD. I don't know of any other institution that does exactly that. There are some other institutions that are willing to disclose their policies, as well as how they have voted in individual instances.

We have recommended in a report that we did for the Labor Department, submitted to them earlier this month, that they consider a number of actions, one of which would be to require disclosure by ERISA fiduciaries of their voting policies and their voting procedures. One might even consider going further and saying how they voted on individual cases.

Senator COHEN. You could have a policy and then have a different vote?

Mr. HEARD. That's possible, certainly. I don't think anything we come up with here or anything that the Labor Department comes up with is going to deter people who have no interest in meeting their fiduciary responsibilities.

I do think, however, that policy statements on the part of the Labor Department serve to underscore to the investment community the importance of the issues. Disclosure will help people do the right thing, not that we know in advance necessarily what the right thing is in every instance, but I do think that the beneficial effects of disclosure are worth the effort.

Senator COHEN. Did you make any recommendation with respect to the so-called Peter Drucker rule; that is, maximize profits. Take the money and run.

Mr. HEARD. No, we didn't. That wasn't the focus of what we were asked to do.

Senator COHEN. Doesn't that have to be part of the policy that is articulated by DOL? If you're going to have a policy, there has to be some discussion of whether you can go for the highest immediate profit, or whether you are required to assume the burden of taking a long-term view. In other words, whether or not you have to forego the initial attractiveness and appeal of, for example, a cash offer, and consider what the long-term results are going to be.

It seems to me if you're going to argue for a policy, the policy has to make some determination on that issue.

Mr. HEARD. I would state, Senator, that that's something that might be included in anything that the Labor Department might look at. We, frankly, were more concerned in the work we did for the Labor Department in looking at voting decisions in regard to items that appear in proxy statements, shark repellants and so on, than we were with some of the other issues. But they all do tend to go together.

Senator COHEN. I'm not that familiar with the area, but it seems to me that you can't issue a statement dealing with shark repellants, for example, unless you set forth what you think the burdens and responsibilities of a fiduciary are in terms of analyzing the immediate capital gain, as such, or cash realization, as opposed to the long-term gain.

You can't separate those, I don't think.

Mr. HEARD. I think I would agree with you. And I think the Department has, through its enforcement actions, as Mr. Lilly indicated earlier, in the case of the use of plan assets in a contest for control, such as the Grumman case, and in other instances, used enforcement to articulate a policy there, and perhaps it's worthwhile to pull it all together in a policy statement.

Senator COHEN. Did you find evidence in support of the allegations or suggestions being made that a number of investment managers are voting in ways that might be inconsistent with the interest of the pension funds because they're under pressure from corporate management?

Mr. HEARD. We have been told by a number of individuals that this is going on, to some extent. It's not the sort of thing that people want to say for the public record. I'd have to say that we've been told in confidence by a few people that this has happened in their institutions. I'm not sure how one would ever prove that that was the case.

Senator COHEN. If you had an individual working for an investment firm and he got a call saying that we have just deposited $10 million in pension funds for you to manage and we expect you to reciprocate by supporting our management against a takeover, I suppose if he failed to do that and lost his job or got fired, that might be one way of discovering it.

Mr. HEARD. If you had some whistleblowers willing to step forward and blow the whistle in that situation, perhaps so.

Senator COHEN. Absent that, it's very difficult.

Mr. HEARD. Absent that, it's very difficult to prove.

Senator COHEN. One of your recommendations to the Department is that they examine the division of decisionmaking authority of corporate governance issues among pension plan sponsors and outside managers. You raise a number of questions and suggest that they need be explored before any action is taken.

Would you elaborate a little bit on that? Are you suggesting that the plan sponsors assume the voting responsibilities?

Mr. HEARD. I'm suggesting that that issue deserves some exploration. My own view is that it doesn't really solve the problem. If the problem is one involving potential conflicts of interest, it doesn't seem to me that you solve that problem by pushing voting decisions back on plan sponsors. Plan sponsors could easily and are likely to find themselves in the same situations that present conflicts of interest.

Senator COHEN. Either as a target of a takeover or engaged in a takeover themselves?

Mr. **Heard**. That's right, or in the case of, say, voting on shark repellants, there will be customer-supplier relationships, board interlocks and so on.

I think looking for a way to get rid of potential conflicts of interest is the wrong way to go. I think what you need to do is find a way to manage potential conflicts of interest so that you get people making decisions that are based on their fiduciary responsibilities.

Senator **Cohen**. Mr. Gray, do you have anything that you would like to add to what has been said here?

Mr. **Gray**. [Nods in the negative.]

Senator **Cohen**. You've been a silent witness. [Laughter.]

Mr. **Gray**. I wish we could tell the Senator some of the stories we've heard from money managers about the pressures that they've received.

Senator **Cohen**. Why don't you tell us some of the stories?

Mr. **Gray**. Well, an example might be of a major bank that votes against a shark repellant and a person at the trust department who authorizes the vote is told that the bank will be excluded from any of the commercial lending activities.

Senator **Cohen**. That can't take place, though. There's a Chinese wall——

Mr. **Gray**. No, the corporation that is proposing the resolution tells the trust officer that we're not going to borrow money any more from your bank. And, of course, the trust officer isn't involved with commercial lending and he's fairly honest, and so he votes the way they want. And now the corporation continues to boycott, I guess, the bank's commercial lending department, to no avail.

But it seems that in other cases people may be more willing to respond to that kind of pressure.

Senator **Cohen**. Is this what the money managers are coming to you and telling your organization?

Mr. **Heard**. They're not dozens of them coming to us and telling us this, Senator, but we've been told by several that this has happened. There are individuals in institutions that we have had fairly longstanding relationships with.

My own guess is that this is going on on a much wider scale than we know about. If, indeed, the kinds of pressures that are being applied to money managers are being applied on a very widespread basis, it's only logical to assume that it's going on on a wider scale. The problem is, again, one of proof. How would you ever prove that that's what actually happened?

Senator **Cohen**. Gentlemen, I am going to include your full statement in the record. I want to indicate to those who are still here and who have suffered through 2 days of these hearings that I believe that there are serious issues that need to be addressed by both the Department of Labor and certainly by the U.S. Congress in dealing with the ERISA Program.

[Mr. Heard's prepared statement follows:]

PREPARED STATEMENT OF JAMES E. HEARD

My name is James E. Heard. I am deputy director of the Investor Responsibility Research Center and director of the Center's Corporate Governance Service. With me today is senior research analyst Hillel Grav. We appreciate the subcommittee's invitation to testify today on the role that pension funds play in the corporate governance process.

The Investor Responsibility Research Center is a not-for-profit corporation established in 1972 to provide impartial reporting and analysis of policy questions for institutional investors. We do not make recommenations to our clients; our research is intended to give them an informed basis for making their own decisions. Our research services cover three broad areas: social issues in the form of shareholder resolutions that come to votes at annual meetings of major corporations; business activities of U.S. corporations and banks in South Africa; and corporate governance issues that affect shareholders' rights and the value of their investments.

We have a diverse clientele of almost 200 institutions, consisting of colleges and universities, foundations, church groups, public and private pension funds, bank trust departments, insurance companies and investment management firms. Our clients include some of the largest pension fund managers in the country.

The focus of our testimony today is on the role that institutional investors--pension funds in particular--play in the corporate governance process. Pension funds (including public pension funds) are now estimated to have more that a trillion dollars in assets, and they own more that 30 percent of the stock in our publicly held corporations. Their size puts pension funds in a position to exercise significant influence in corporate decision-making.

The Wall Street Rule

Traditionally, financial intermediaries such as bank trust departments and insurance companies have taken a passive role in the corporate governance process. Most have followed the "Wall Street Rule" of supporting the managements of companies in which they hold stock when issues are put to shareholders for approval.

The rule gained acceptance at a time when institutional stock holdings were relatively small, controversial items presented for a vote relatively few, and standards of institutional accountability in American society somewhat less demanding.

The decade of the 1970s witnessed significant changes. Fueled by the rapid growth of pension fund assets under institutional management, stock holdings of institutional investors increased dramatically. Thus began the demise of the Wall Street Rule, as the size of institutional holdings began to affect both the liquidity of those holdings and the attitudes of institutions about their fiduciary responsibilities. The enactment of the Employee Retirement Income Security Act (ERISA) in 1974 established federal fiduciary standards that have heightened sensitivity about the role that pension funds play in the corporate governance process.

The recent wave of highly publicized mergers and takeovers has drawn attention to efforts by incumbent managements to create barriers to hostile tender offers in the form of "shark repellent" amendments to their corporate charters. Some major financial institutions acting as fiduciaries have taken strong exception to these proposals, which many regard as contrary to the interests of the beneficial owners.

At the same time, however, financial institutions managing pension funds and other fiduciary accounts have business relationships with corporations that can create potential conflicts of interest. These potential conflicts of interest put pension fund managers in the position of possibly violating their fiduciary responsibilities under ERISA if they act to advance their own business interests rather than to protect the interests of pension fund participants.

Current Voting Policies of Investment Managers

Since 1981, our firm has conducted three extensive surveys of how investment managers are voting on antitakeover charter amendments and other corporate governance issues. The respondents to these surveys have included major bank trust departments, insurance companies and investment firms that are responsible for managing large amounts of pension fund assets subject to ERISA.

Among the results are the following:

- Very few of the investment managers responding to our surveys indicate that they treat antitakeover charter amendments as routine items. Most firms report that they have established special policies and procedures to examine antitakeover charter amendments and other corporate governance issues.
- Most investment managers responding to our surveys believe that antitakeover charter amendments are contrary to shareholders' interests. Some vote against all such proposals as a matter of policy; others review them individually. Firms that review the proposals individually support them on occasion, but many put the burden of proof on each company to offer persuasive reasons why the proposals should be approved.
- During 1984 we witnessed a greater willingness on the part of some investment managers to consider the merits of individual fair-price

proposals, but even so, more than half said that they usually oppose fair-price proposals as a matter of policy.

- Widely publicized episodes in which corporations have used preferred stock to create so-called "poison pills" have made investment managers increasingly wary of approving so-called "blank check preferred stock." Many now regard requests to authorize blank check preferred stock as a major antitakeover device, and many are voting against such authority. Two-thirds of the investment managers responding to our 1984 survey said they usually vote against such proposals, while a number of others said they put the burden on the management of each company to demonstrate the need for preferred stock.

The investment managers that respond to our surveys are not necessarily representative of all investment managers, and in fact there is some reason to believe that they are unrepresentative. Their willingness to subscribe to our services, to take the time to answer our inquiries and to share information with us sets them apart from many other firms that have been less willing to devote time and resources to independent examination of the issues. Thus, the fact that some institutions are acting in a responsible manner should not obscure the fact that many others probably are not.

Policies of Plan Sponsors

Plan sponsors subject to ERISA have remained largely passive in the corporate governance process, with the notable exception of takeover battles in which plan sponsors have become either bidders or targets. A major reason for this passivity is the widespread use of outside investment managers by corporate pension funds. According to the 1985 edition of Money Market Directory, 58 of the 100 largest corporate pension funds use outside investment managers exclusively. Of the 42 that use in-house management, many manage only cash or bonds internally and rely on outside managers for equity investments. Among smaller pension funds, the use of outside managers is even more common for equity investments.

The common practice among plan sponsors using outside managers is to delegate to them responsibility for voting portfolio securities.

It is noteworthy that no corporate pension funds testified at the Labor Department's January 1985 hearings on corporate governance. Furthermore, although several attended exploratory meetings in late 1984, no corporate pension funds have seen fit to join the newly formed Council of Institutional Investors, which consists almost exclusively of public pension funds.

Of the nearly 200 institutional investors that are clients of the Investor Responsibility Research Center, only two are corporate pension funds. Very few corporate pension funds have responded to our surveys on voting policies and practices. The few exceptions involve very large corporate pension funds with internal management. These funds have voting policies and practices that are similar in most respects to the policies of investment managers that I described earlier.

Conflicts of Interest

Potential conflicts of interest are not uncommon for investment managers who must observe ERISA's fiduciary requirements and who also wish to cultivate good relations with existing and potential clients. In addition to their responsibilities as fund managers, many banks and insurance companies have other relationships with corporations that create opportunities for conflict. Banks, for example, may serve as commercial lenders to, and insurance companies may be insurance underwriters for, companies whose pension funds they manage. Personal relationships among senior executives, including service on boards of directors of major customers, may introduce additional complications.

Reluctance to offend customers is frequently mentioned as one of the principal reasons why institutional investors traditionally have preferred to avoid making voting decisions that are opposed by the managements of portfolio companies. The appearance in proxy statements of antitakeover charter amendments and other items that may diminish the rights of shareholders or affect the value of their investments puts investment managers in a position where they may be required to choose between their fiduciary responsibilities and their own financial interests.

Testimony given at the Labor Department's corporate governance hearings in early 1985 suggests that some pension fund managers are putting other considerations ahead of the best interests of pension fund participants. One of the nation's most respected money managers, Dean LeBaron of Batterymarch, said at the hearings:

> Institutional investors have a poor record for statesmanlike behavior in protecting their interests in voting against limitations on their own rights as shareholders.
> I'm told that institutions have been voting more nearly in favor of limitations of their own rights this year. There may be shortsighted commercial reasons for doing so because any other explanation seems impossible. Perhaps there has been mild, friendly persuasion to encourage these votes. Certainly institutional investors have not been in the forefront in assuming a militant position in favor of their own rights.

The hearings also produced evidence that corporations have exerted pressures on investment managers to support actions that may be contrary to the best interests of pension fund participants. David L. Heald, vice president and general counsel of First Chicago Investment Advisors, testified, "We have had certain situations where there were apparent threats...suggesting to us that if we proceeded with our particular position they might want to find another commercial banking arrangement."

A number of persons have reported to us that companies seeking shareholder approval of antitakeover charter amendments are becoming more aggressive in seeking shareholder ratification. In some cases their efforts have involved discussions with investment managers that attempt to convince them of the merits of the proposals, but in other cases companies have attempted to exert greater pressure on investment managers to support proposals. We also have been told of several instances in which institutions have changed their voting policies as a result of these pressures.

These pressures seem to have intensified considerably within the last 18 months, as the number of major corporations seeking approval of antitakeover charter amendments has increased. We are not certain how frequently these pressures cause investment managers to support proposals that they otherwise would be inclined to oppose, but it would be naive to suppose that such instances are either nonexistent or uncommon. Even if corporate clients exert no direct pressure, the very existence of a business relationship may influence investment managers to put their own self-interest ahead of their fiduciary responsibilities.

The reluctance to offend clients may be one of the major reasons why antitakeover charter amendments are so rarely defeated, even at companies that have substantial institutional ownership.

There are numerous other instances in which conflict of interest problems may arise. The use of pension fund assets in contests for corporate control presents especially troublesome conflict-of-interest problems for pension fund sponsors, trustees and investment managers. Plan sponsors and trustees named by management may be tempted to use plan assets either to acquire the assets of other companies or to defend against hostile takeover attempts. Investment managers also face potential conflicts of interest in battles for corporate control. For example, a bank serving as trustee for an employee savings plan holding a substantial amount of stock in a corporation that becomes a target of a hostile takeover attempt may also have a close commercial banking relationship with the target company. The bank's fiduciary obligation to savings plan participants and its wish to maintain its banking relationship with the target company's management may create a potential conflict of interest.

The growing popularity of employee stock ownership plans (ESOPs) and other employee ownership programs encouraged by recent changes in federal tax law is likely to mean that plan sponsors, trustees and financial intermediaries serving as trustees for such plans will be forced to confront such situtations more frequently in the future.

Labor Department Oversight

The U.S. Department of Labor has major responsibilities for administration and enforcement of ERISA. We are not in a position to evaluate critically its actions, but the Labor Department does seem to understand the potentially harmful effects that misuse of pension fund assets may have in a contest for corporate control, and it has resorted to court action against pension fund sponsors and trustees on more than one occasion. The Department is aware, too, of the potential for abuse in the creation establishment of ESOPs, particularly when they are established hastily in the midst of a contest for corporate control.

The Department also is becoming increasingly aware of the importance of voting issues. In public remarks and in hearings this January, Robert A.G. Monks, former administrator of the Department's Office of Pension and Welfare Benefit Programs, helped to raise consciousness about the issues among fund sponsors and managers.

In a report to the Labor Department earlier this month, we suggested several actions that the Department could take to strengthen its oversight of the role that pension funds play in the corporate governance process:

- First, the Department of Labor should consider issuing a policy statement on the subject of pension funds and corporate governance issues setting forth its views on the responsibilities of ERISA fiduciaries in regard to corporate governance issues. The statement might include matters such as voting on corporate governance issues and the activities of fiduciaries in regard to contests for corporate control. Such a statement would serve notice to ERISA fiduciaries that the Department considers careful attention to corporate governance issues to be a consequential matter, and it also would provide guidance to plan sponsors, trustees and investment managers.
- Second, more complete information is needed about the activities of pension funds in regard to corporate governance issues. Our own surveys provide insights into the policies of major institutional investors, but information is needed about the policies of a broader spectrum of investment managers. Very little information is available about pension fund sponsors; although it appears that most pension fund sponsors delegate responsibility for decision-making on corporate governance issues to their outside investment managers, there is almost no recent empirical evidence about their policies. To remedy these deficiencies, the Department of Labor should consider conducting its own survey of ERISA fiduciaries, including plan sponsors, trustees and investment managers.
- Third, the Department of Labor should consider requiring pension fund sponsors and managers to disclose publicly their voting policies and procedures on corporate governance issues. This would give the Labor Department and other interested parties, including Congress, much needed informa-

tion. It also would serve to promote compliance by fund sponsors and managers with ERISA's requirements.

- Finally, the Department of Labor should examine the division of decision-making authority on corporate governance issues among pension plan sponsors and their outside managers. In the matter of voting rights, the common practice of plan sponsors has been to delegate voting responsibility to outside managers. It has been suggested by some observers that voting should be the responsibility of plan sponsors. Supposedly, this would place responsibility closer to the beneficial owners, whose interests are at stake, and it would relieve financial intermediaries of the conflicts of interest that they often face in voting or in making other decisions related to contests for corporate control.

While the idea of shifting responsibility onto the shoulders of plan sponsors may have merit, a number of questions must be considered. Given the apparent indifference of plan sponsors, is it reasonable to expect that they will conscientiously discharge their responsibilities? Do plan sponsors, particularly the sponsors of smaller plans, have the resources to assume these responsibilities? Are plan sponsors any less likely than outside managers to be burdened by conflicts of interest? Are they any more likely to resolve potential conflicts of interest in favor of plan participants? If plan sponsors are to assume full responsibility for corporate governance issues, is it advisable to require the use of independent advisers, professional trustees or employee representatives to assure that the interests of plan participants are protected? These and perhaps other issues need careful exploration before any action is taken.

Conclusions

Developments of the last decade have thrust pension funds into the corporate governance system in ways that few could have imagined when the Employment Retirement Income Security Act was adopted in 1974. The growth in the size of pension fund assets, and the investment of sizable amounts of these funds in common stocks, have made pension funds major owners of corporations. At the same time, the development of corporate governance issues that can affect the rights of shareholders and the value of their investments means that pension funds, their investment managers, and others who act as fiduciaries must carefully consider current corporate governance issues if they are to meet their responsibilities. Oversight hearings such as those being conducted by this subcommittee are timely, and they can help to ensure compliance with ERISA's requirements.

Senator COHEN. I mentioned before in my opening remarks that we have questions dealing with the single agency, whether or not there ought to be an independent trustee, and whether we should turn to SRO's. Indeed, in regard to SRO's, whether they're even legal at this point and whether they're feasible given the kind of diversity found within the financial managment industry. It may not be feasible to put together an SRO that could be patterned after those that are involved in the securities industry.

In addition, there are issues dealing with corporate governance, electronic filing of the 5500 form, schedule A hiring authority, and the question of whether or not there is, in fact, a long- term policy? I believe there is not. The question is whether there should be. There is also the question of asset reversion schemes that might not be working to the betterment of the overall ERISA program.

These, I believe, are subject matters which the Congress ought to address. I hope to be making, based upon the information we've received here, plus the information that has been gathered by the Department of Labor, some positive recommendations to the Senate and hopefully to the Congress, later this fall.

I also want to raise the question of whether or not the Permanent Subcommittee on Investigations ought to pursue an issue which has not been well documented but has been left in the realm of allegation, rumor, and isolated cases. Nonetheless, in my judgment, the conflicts of interest pose a significant threat in the future due to the accumulation of so much money and a growing concentration of that money into fewer and fewer firms. I think it raises the potential for even more abuse and it will become not just a hypothetical or isolated case but, rather, a pervasive and widespread practice.

I think that the Permanent Subcommittee on Investigations ought to consider at least investigating this very substantial and serious threat in the future.

I thank you for your testimony and I thank those who have sat through these hearings for your patience, and once again I would thank the committee staff, Kim Corthell, Susan Collins, and Mary Gerwin, for their heroic undertaking to try and analyze the ERISA statute and the practices that are prevailing in the industry.

Thank you all.

The committee will stand adjourned.

[Whereupon, at 11:30 a.m., the hearing was adjourned to reconvene at the call of the Chair.]

ADDITIONAL MATERIAL SUBMITTED FOR THE RECORD

U.S. Department of Labor
Office of Pension and Welfare Benefit Programs
Washington DC 20210

January 20, 1985

ADMINISTRATOR'S REPORT TO THE SECRETARY

As Administrator of the Office of Pension & Welfare Benefit Programs (OPWBP) during the last year, I would like to account to the Secretary of Labor for my stewardship. The range of work that has been undertaken in 1984 is sufficiently wide to require Appendices on individual topics; this memorandum will briefly summarize our activities.

As will be evident from the summary, our efforts have led us to several basic conclusions about this office and its statutory responsibilities.

First, the magnitude of ERISA, and its impact on the American economy, are only beginning to be understood by its constituences.

Second, the corresponding scope of ERISA administration is wide and complex. Congress was fairly close to the mark in its initial recommendations that a 2000-person staff would be needed to fulfill statutory requirements spelled out in the act. Current staffing levels are drastically short of that, and have led to corresponding weaknesses in carrying out the law.

Third, the various reviews conducted this past year of OPWBP's performance have highlighted the areas that must be strengthened if the office is to be functional. They are:

a. Enforcement

b. Information management

c. Exemptions processing

Fourth, the initiatives outlined below, which would greatly strengthen these areas, require sustained leadership and commitment by the Department, not only in internal processes but also with regard to involvement with the Office of Management and Budget, appropriate Cabinet Councils, and Congressional committees. In the absence of such commitment, they will most surely be in vain.

All of these initiatives were developed in an atmosphere of support and progressivism under the leadership of Secretary Donovan. They are consistent with Administration policies of deregulation and public-private sector partnership. It is my fervent hope that they can be carried on to timely implementation.

Annual Report of Administrator - 1984

INTRODUCTION

In late 1983, Secretary Donovan came to the conclusion that PWBP was a sorely neglected program. Accordingly, when he hired me as Administrator, he directed me to move rapidly to assess the office's performance and to develop initiatives to strengthen it. He also took action to separate PWBP out from LMSA, and directed that I report directly to him. Throughout the year, the Secretary made it clear that he considered the revitalization of OPWBP one of his priority concerns, and I have received excellent support from the Secretary's staff, the Office of the Solicitor, and the Assistant Secretary for Administration and Management throughout my tenure.

Departmental support is described in an Appendix separately delivered to the Secretary.

Above all, I am grateful to the senior career officials of OPWBP for their loyalty, their hard work, and their commitment to making OPWBP a professional organization of the highest calibre.

As a result of all these factors, our accomplishments have been substantial. The most important, from my perspective, has been the willingness of Department officials openly to consider the problems of OPWBP, and to solicit advice from interested constituencies in the process. The willingness to listen and to exchange views has fostered a partnership of trust and cooperation with the groups that deal with OPWBP, and has created an attitude of tentative credibility for the program.

My principal regret lies in an inability to persuade Senators, Representatives, and their staffs to become more involved in the ERISA program. This situation is increasingly troublesome given the departure from Congress of all of the original ERISA sponsors; it will have to be remedied if OPWBP is to contribute effectively to the development of a national retirement income policy.

The following summary is broken out into three areas of concern: organization, operations and policy.

I. ORGANIZATION

1. Separation of PWBP from LMSA. Both the national and the field offices of PWBP were separated from LMSA by August 1984. This separation required a new organizational structure, new job descriptions, new grades, and a staggering amount of detail; these tasks notwithstanding, the work was finished in record time.

2. National Pension Forum. In June, the first session of the National Pension Forum was convened by Secretary Donovan. The Secretary invited a full and open analysis of OPWBP's operations during the previous ten years, and asked for recommendations on how the Department of Labor could improve its organizational structure so as to fulfill its obligations under Title I of ERISA. (The mission and structure of the Forum are described in Appendix A.)

The Forum had three full public meetings in June, September and December, with smaller working sessions in October and November. Forum members concluded that the Secretary should continue his efforts to make OPWBP a separate and distinct unit within the Department of Labor, and to promote the professionalism of its staff. Among other things, the Forum recommended that principal executive of OPWBP should have the rank of Assistant Secretary, and that the agency should have limited authority to hire professional employees under Schedule "A". (The entire transcript of Forum proceedings and recommendations are attached as Appendix B.)

3. Enforcement. ERISA enforcement has been the focus of repeated criticism. No fewer than seven reports by several different groups (the Inspector General, the General Accounting Office, and the Senate Permanent Subcommittee on Investigations) have concluded that the Department's performance is totally inadequate. A significant amount of

work was therefore devoted to this subject during 1984. In March, I convened the Enforcement Task Force Force under the Chairmanship of the Deputy Inspector General. The Solicitor's Office provided the Executive Director of the Task Force, who received a special Departmental award and bonus for his extremely competent work.

The Task Force included those in the Department of Labor who are most knowledgable about ERISA enforcement issues, irrespective of what agency they worked for. Thus we had the full participation of the Solicitor's Office, the Office of the Inspector General, the regional offices of OPWBP, the area and national offices of OPWBP, and a participating observer from GAO. The Task Force ultimately reported to Solicitor Lilly, Inspector General Hyland and myself; we in turn reported to the Secretary. The Task Force report (attached as Appendix C) clearly indicates that at no time since the enactment of ERISA have sufficient funds been appropriated to permit enforcement comparable to that of the SEC, the IRS, or bank regulatory agencies. Furthermore, the Act's sponsors contemplated that a staff of approximately 2000 people would be necessary to administer ERISA. This staffing level was never realized; unfortunately, the expectations established for the enforcement office were not scaled back commensurately with the reduced staffing levels. It is crucial that in its reorganization, OPWBP be able to communicate realistic enforcement goals based on available resources.

Following completion of the Task Force report, we selected a new Assistant Administrator for Enforcement. More than 100 individuals applied for the position, and we were able to select an extremely well qualified applicant who has extensive enforcement experience at the SEC.

The new Assistant Administrator has undertaken to reorganize the office so as to best utilize current resources. Considering available personnel and the unlikelihood of future funding increases, a consolidation of our field offices from a present level of 25 down to 10 seems appropriate. While we will have an effective national office and effective field presence in selected areas, this consolidation will exact a significant price in reducing awareness of the program anywhere outside the largest metropolitan areas.

4. Planning. OPWBP has undertaken a formal planning process for each of its units. We have asked each assistant administrator to set specific goals for one and three year periods. These goals were developed in serial conferences with myself and my Deputy for Programs Operations, and will be used as the basis for both new performance standards and annual evaluation of agency managers and executives. (A copy of the planning documents is attached at Appendix D.)

5. Professionalism. All the efforts undertaken in 1984 indicate that OPWBP needs to devlop a "culture of

professionalism". ERISA imposes demanding requirements on OPWBP staff; many of their tasks are analogous to those performed by specialized financial regulatory agencies such as the IRS, the SEC and the Federal Reserve. In examining OPWBP's needs, we were fortunate to have the assistance of Frank Yaeger, who was loaned to us by Assistant Secretary Tom Komarek. After several months of consultation, Frank wrote a final report (see copy at Appendix E), which outlines ways in which integrated training programs can be used to upgrade performance and professional standards. Frank's recommendations are very valuable, and have confirmed our belief that retaining funds for training is critical to the future of OPWBP.

II. OPERATIONS

1. Class Exemptions. The year began auspiciously with the publication of QPAM regulation, one of the most significant deregulatory accomplishments of this Administration. We had equal success at year's end with OMB's December 31 approval of the "plan assets" regulation, a proposal that represents ten years of work. A significant class exemption was also issued in the area of real estate investments. This exemption permitted a wider range of investments to be defined by national rating services rather then simply those issued or guaranteed by an instrumentality

of government. A full list of the class exemptions issued during the year is attached as Appendix F.

2. Individual Exemptions. ERISA specifically provides in §408 that the Department has the authority to exempt certain transactions from being deemed "prohibited transactions". The backlog incurred in processing the exemptions has recently been quite large. It is a pleasure to report that the backlog has declined in 1984 from some 600 pending applications to under 350, an accomplishment that is due substantially to the dedication and tenacity of acting Assistant Administrator Elliot Daniel. (A statistical table describing individual exemption backlogs over several years is attached as Appendix G.)

At the beginning of the year, we learned that many commercial interests in Alaska were particularly dissatisfied with OPWBP's response to them. Many of the key personnel in the agency served on an "Alaska Task Force" which by year end had made sufficient progress to receive congratulatory letters from both U.S. Senators and from counsel to the Alaska interests (all collectively attached as Appendix H).

3. Enforcement Performance. Early in 1984, I made a conscious decision that it would be best to focus our attention in the enforcement area on organization, securing the best possible Assistant Administrator, and defining a

realistic mission. Accordingly, we have not had a distinguished year from the point of view of enforcement statistics.(A tabular summary is attached as Appendix I).

It is very plain that the Administrator's job is aided greatly by the dedicated and effective lawyers in the Solicitor's office. Substantial progress was acheived this year on settlement of the decade-long cases against the Central States Teamsters. We hope that the settlement concluded in recent days in the Southern California Foundation case will serve to educate all parties on the permissable scope of "social investment".(A copy of the decree is attached as Appendix J).We have also worked hard to focus enforcement efforts on the use of "soft dollars", an effort which has engaged Deputy Administrator Klevan. We have held several training sessions and have begun the development of appropriate cases in this area.

4. Research. During the past year, much of our time and effort went towards reestablishing the program as the central pension research organization in the government. OPWBP reports were published and disseminated in various venues, and several large scale projects involving data collection and analyses were inaugurated.

OPWBP is in the process of compiling the first Handbook of Pension Statistics. The handbook publication is of special importance because it represents the first of a bi-annual handbook release which reports the results of major pension studies done by in-house and contract personnel and which contains over 50 pension data tables. It is expected that this book will become a standard reference for professionals working in the government and in the pension industry.

Two other large scale projects were started during the year.

1. 5500 Statistical Sample Tape Creation, 1981, 1982.

This project represents a recommitment by OPWBP to maintain data describing the important features of the pension plan universe. This report was last completed for the 1977 plan year.

2. Study of Pension Rates and Returns

This project represents a seminal effort to measure the performance of pension and other trust portfolios. No academic or industry group has previously engaged in this inquiry. The study will incorporate pre and post ERISA data for ERISA and non-ERISA funds. It will document performance and portfolio characteristics of these trusts and will measure their transactions costs and trading efficiency. Potentially, the result of this study could have dramatic implications for pension policy.

Finally, the office produced or started three OPWBP/GPO publications:

1. Private Pension Benefit Levels, 165 pp.
2. Pension Economics, 373 pp.
3. Handbook of Pension Statistics, in progress, est. 350 pp.

III. POLICY

Policy guidelines from the Secretary and the Administration have defined my agenda. The themes that most accurately characterize our initiatives in 1984 are deregulation and public-private sector partnership. In addition, we have stressed the establishment of open dialogue with the private sector. As a part of this effort, we have undertaken the following projects:

1. Electronic Filing. In January 1984, we started a pilot project in which approximately 1000 ERISA annual reports

have been filed electronically with the Department. We are currently in the process of evaluating the results of this pilot project: measuring the cost and time savings to the government and to the filers, testing analytical exercises that can performed on the data base, and applying the utility of such data to all OPWBP functions. The evaluation is being conducted with the MITRE Corporation, the systems engineering firm which designed the pilot, as well as with the other federal agencies that use ERISA data -- the IRS, PBGC, and Social Security Administration. OPWBP has also succeeded in asking the Office of Management and Budget (OMB) to convene an electronic filing working group, comprised of the four agencies mentioned above and chaired by OMB. This group will study the long-term planning associated with taking electronic filing nationwide and evaluate the feasibility of making it a joint venture. The first meeting of the group was held December 21.

It is important to note that OPWBP has oversight responsibility not only for pension plans, but also for approximately four million welfare (health, life insurance, vacation, etc.) plans that cover more than two thirds of the American people. I must report that as we have had some initial success in preventing unlawful misuse of pension funds, the instances of abuse of welfare plans has apparently increased, clearly involving some major elements of organized crime. It has been acutely embarassing to be asked to testify before Congress on this topic, and to be forced to admit we know virtually nothing at all about welfare plans. Electronic information management is the only reasonable way to correct this problem.

The Secretary's support for the electronic filing concept was crucial in getting the pilot off to a solid start in early 1984. We were also fortunate to be operating in the slipstream of the SEC, which had spent substantial time and money developing a similar pilot for the filing of 10K Forms. OPWBP spent months laying careful groundwork for this project, and it more than paid off; the reception from filers, their service providers, such as banks and accounting firms, and from the press has been extraordinary. The only reservation voiced at any time was the hope that the government would in fact commit itself to an electronic system -- not simply run a pilot, declare it successful, and then not implement it expeditiously. Clearly, this system can achieve significant savings, improve the accuracy and timeliness of the information, and make it possible for all OPWBP components to better fulfill their responsibilities. It would be a major loss if this project doesn't receive the support necessary to move forward.

2. Self-Regulatory Organization. The problem of backlogs in important class and individual exemptions seems to be endemic to OPWBP. The broad prohibited transactions

provisions of ERISA serve to prevent the use of pension plan assets to benefit individuals and entities who have "an inside relationship" with the plan. The Department has utilized these provisions in a number of successful enforcement proceedings to prevent the abuse of pension funds and to achieve substantial recoveries where funds have been lost. These proceedings included cases against the Central States Teamsters plan and the Southern Nevada Culinary Workers plan.

Despite their enforcement effectiveness, the breadth of these provisions has a chilling effect on a wide variety of otherwise appropriate transactions between plans and related parties. Congress recognized that many of these transactions should not be prevented and gave the Department and the IRS jointly the authority to grant exemptions from the prohibited transactions provision. (In 1978 the IRS' authority was transferred to the Department.) Over the years, the Department hs granted many class exemptions that relate to entire industries such as securities, insurance, banking, and real estate; these exemptions, combined with the recently issued QPAM exemption, have been extremely successful in permitting plans to engage in normal business relationships. Each year, however, OPWBP receives an increasing number of individual exemptions for transactions that are not covered by these class rules. Our current rate of receipts, for example, is approximately 500 percent greater than that in 1978. In spite of increased staff productivity during this time, the sheer volume of cases has resulted in backlogs and delays which produce three unacceptable results. The complexity of financial transactions requires rapid decision-making; to wait months, and even years, for an exemption can mean the loss of investment opportunities that could otherwise benefit plan participants. Delay can also result in two other negative results: parties cease investing in particular kinds of transactions, or the transactions simply become more and more costly. For OPWBP staff to turn their attention to class exemptions, they would have to cease processing daily individual exemptions. As a practical matter, this is impossible.

Projections indicate that by the turn of the century, fully half of the equity in American corporations will have come from ERISA funds. There will therefore be a growing need for exemption competency in an area of rapid change and complexity. It is highly unlikely that OPWBP will be granted the number of additional personnel required to handle the kind of volume that can be anticipated. Thus, we are confronted with the need to develop a new mechanism that could enhance the capabilities of OPWBP's current staff. We presented the idea of a self regulatory organization (SRO) to the National Pension Forum and secured its approval to publish a Federal Register notice soliciting comment on the idea. (A copy of this notice appears in Appendix L.) Specifically, we have asked for comments on the structure and membership of an SRO, the ways in which it might complement the professional expertise of OPWBP, and the kinds of transactions it might consider in offering assistance to its members. Essentially, it offers the private sector an opportunity to help itself.

3. Fund Performance/Corporate Governance. Clearly, ERISA has produced a new phenomenon in the American economy. The size of the funds subject to ERISA will rise from today's $1 trillion to $3 trillion (1983 dollars) by the turn of the century. ERISA is having an extraordinary impact on the underwriting industry -- a full one-half of the funds for both debt and equity underwritings in 1983 came from ERISA. Furthermore, the current spate of take-overs is influenced heavily by the fact that a large percentage of shareholders are fiduciaries with a corresponding sensitivity to obtaining the highest price for their beneficiaries. (See Appendix M for a copy of an editorial by Peter F. Drucker and a response by myself, both of which were published in the Wall Street Journal in late autumn 1984.)

In order to have a better understanding of the performance of ERISA funds over the last ten years, and the role of ERISA fiduciaries in matters of corporate governance, we have called two sets of hearings in January -- one in New York City and the other in San Francisco. Approximately sixty witnesses will testify on these two subjects. (A copy of the notice for the hearings appears as Appendix N.) The transcript and summary conclusions from the hearings will be made available as a part of this report as soon as possible,and will appear as Appendix O.

4. Statements. In light of ERISA's pervasive impact on the American economy, I have felt that it was important to speak out on significant issues. Accordingly, I have given over 25 formal addresses during the past year. The following subjects were of particular importance.

a. Social investing (Appendix P)

b. Duties of a trustee shareholder (Appendix Q)

c. Investment performance under ERISA (Appendix R)

d. The lack of ERISA constituencies (Appendix S)

THE NATIONAL PENSION FORUM
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1974-1984

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INTRODUCTION

On September 2, 1974, the Employee Retirement Income Security Act (ERISA) was signed into law, marking a new era in pension reform. In this year of ERISA's tenth anniversary, the Secretary of Labor established the National Pension Forum as a means by which to undertake an objective, bipartisan review and analysis of the Department of Labor's effectiveness in carrying out its administrative responsibilities under Title I of ERISA.

Comprised of members of the Executive and Legislative branches of the government and representatives from the pension industry, organized labor and the general public, the Forum was requested to review the Department's responsibilities under Title I of ERISA, as well as its performance of those responsibilities during the last ten years. Based on information gathered from public hearings and work sessions, the Forum's mission was to prepare recommendations for administrative and legislative changes necessary for a more efficient and effective pension program within the Department.

Among the areas identified by the Secretary for the Forum's study were the following: methods by which the Department's data base on pension and welfare plans might be enhanced; the Department's enforcement programs; the continuity of Departmental regulations; the computerization of financial information maintained by the Department for public disclosure; the filing of annual report information electronically; and methods by which the processing of individual exemptions from ERISA's prohibited transaction provisions might be facilitated.

The following report represents the work and the recommendations of the National Pension Forum.

NATIONAL PENSION FORUM

Recommendations for Action by Secretary Donovan

BACKGROUND

The National Pension Forum was organized by Secretary Donovan in early 1984 as one of the essential parts of his commitment to discharge as well as possible the obligations of the Department of Labor under Title I of ERISA. The Secretary instructed the Forum to propose administrative and legislative recommendations to improve the Department's ability to fulfill its statutory responsibilities under Title I, the most important of which is protecting the interests of participants and beneficiaries in private sector benefit plans. Other elements comprising the Secretary's commitment have included the separation of Pension and Welfare Benefit Plans (PWBP) personnel and operations from the Labor-Management Services Administration (LMSA). This process was effectively completed in August 1984.

The Forum is comprised of the statutory ERISA Advisory Council, members of both Houses of Congress and representatives from the Department of Treasury, the Office of Management and Budget, the Council of Economic Advisors, and the Pension Benefit Guaranty Corporation (the Executive branch agencies most directly affecting Labor's Title I obligations). The Forum met formally in June, September and December with working group meetings in October and November. The range of discussions has been broad - in some instances well beyond the original scope of the Forum's mission. It was felt that unfettered discussion would be helpful in generating the final recommendations because only in considering the scope of possible policy limits for Presidential or Congressional action would it be possible to have confidence in making recommendations to the Secretary for organizational focus. However, it is felt that the Forum's final recommendations should be consistent with the Secretary's instructions, and thus formal conclusions will be limited to matters concerned with Departmental organization. There is attached, however, a supplementary section of this report captioned "Policy", with which some members of the Forum, as indicated in the accompanying statements, wish to associate themselves.

FINDINGS

The public interest requires that the Department of Labor substantially improve its prior level of discharge of Title I of ERISA in the following areas:

1. Information Handling. The information contained in annual reports should be timely. Electronic information management is the only way to create an ERISA data base which will support effective enforcement of ERISA's substantive requirements, responsible discharge of the Department's research and policy obligations, and for public information purposes. The present situation is unacceptable.

2. Enforcement. A strong enforcement program is critical to the administration of ERISA. The current program is unacceptable and must be improved.

3. Rule-making and exemption-granting. The lead time necessary for granting exemptions is having an adverse effect on the American economy in preventing the increasingly large pools of capital subject to ERISA from being invested in areas where quasi-judicial action by OPWBP is necessary in order to authorize the transaction. The Forum appreciates the complexity of ERISA issues and applauds the quality of the

agency's professional work. However, the American economy needs to have access to ERISA funds on a timely basis, so either substantial additional personnel or new organizational devices will be necessary.

4. Policy. Up until the present time, OPWBP has not committed itself to providing the statistical and policy leadership required under section 513(a)(2). Resources should be made available and priority placed on this capability.

5. Culture. The obligations of the Department under Title 1 of ERISA require competencies of the highest professional nature - comparable to those of the SEC and the IRS, for example. It is, therefore, necessary organizationally to give OPWBP a sense of autonomy within the Department of Labor, perhaps modeled after the Bureau of Labor Statistics, which has an excellent reputation for the accuracy and integrity of its recordkeeping and the professionalism of its staff.

RECOMMENDATIONS

1. Information Handling

The Forum urges the Secretary to request Cabinet Council and OMB approval for the computerization of the ERISA information management system and for the subcontracting of such a project to private firms if studies show the system would be more cost-effective when operated by an outside party. The credibility of the Department's entire effort under Title I depends on its ability to use the information that is filed in the annual reports. If the Department cannot dramatically improve existing information handling, it will continue to be impossible to use all of the information supplied by the public at considerable cost. This recommendation accordingly is given the highest priority by the Forum.

> ERISA imposes detailed requirements on plan sponsors to file annual reports, to prepare plan descriptions and to file and distribute summary plan descriptions. The Forum heard substantial testimony which indicated that the information contained in these filings is not being effectively managed or utilized. The sheer volume of filings -- over 800,000 annual reports per year -- makes

the addition of personnel seem futile. Indeed, this is an area where digital techniques and computers can be of enormous significance. Thus, OPWBP is proceeding at the present time on a pilot project to demonstrate the feasibility of the electronic submission of ERISA data. Over 1000 plans are participating in the pilot, which will be evaluated by the first calendar quarter of 1985.

The information contained in the annual reports is essential to the work of OPWBP. Good and timely information is the single most important means to carry out several of the agency's statutory responsibilities: policy, enforcement and public information. An electronic data base would also improve substantially the functioning of the agency's quasi-judicial responsibilities. Such a data base containing information now variously filed with the Internal Revenue Service (IRS), Pension Benefit Guaranty Corporation (PBGC) and the Social Security Administration (SSA) would result in increased efficiency and cost savings for those agencies as well.

2. Enforcement

The Forum recommends that the Secretary extend to OPWBP the necessary hiring authority to permit the hiring of lawyers in the pension program at the investigative level. Litigation responsibility would remain in the Solicitor's Office, and existing collective bargaining agreements would be observed.

In considering the Department of Labor's performance with respect to ERISA, the Forum has been struck by the fact that ERISA is totally unlike any other law entrusted to the Department. Not only is the law itself highly technical and complex, but it directly impacts on numerous industries, including securities, insurance, investment banking, real estate, etc., which have traditionally not been within the sphere of responsibility of DOL. Additionally, in both the regulatory and enforcement areas, close coordination with other federal agencies, such as the Internal Revenue Service, the Department of Justice, Comptroller of the Currency, and Securities and Exchange Commission, distinguishes the administration of ERISA from that of other laws enforced by the Department.

In the enforcement area, ERISA investigations require detailed knowledge not only of the complex law itself, but also of the operation of the banking, real estate and securities industries and the investment instruments handled by those industries. In addition, banks, investment advisors, and brokerage firms are integrally involved in employee benefit plans. Agencies such as the SEC which undertake complex investigations similar to those required by ERISA have attorneys conduct the investigations and then handle the litigation resulting from their investigative efforts.

Individual Forum members are aware of ERISA investigations which have taken years to complete only to be referred back to the investigator by the Solicitor because the evidence was legally deficient. On other occasions, the litigation discovery process unnecessarily duplicated most of the steps taken during the investigation because the investigation did not obtain the information in legally usable form.

Congress has long recognized that those areas requiring the special expertise of attorneys could not be properly staffed through the normal personnel practices of government. As a result, a special category of hiring authority was created to apply to employment situations not conducive to normal government hiring policies. The primary occupants of these positions in the Federal government are attorneys.

Granting OPWBP the authority to hire lawyers as investigators would permit the Department to obtain the expertise it needs to handle the complexity of ERISA. Such a move would recognize the fact that ERISA is more akin to the laws enforced by agencies such as the SEC (which has the necessary hiring authority) than to the other programs administered by the Department.

3. Rule-Making and Exemption-Granting

The Forum recommends that the Department of Labor explore the concept of a self-regulatory organization (SRO). As the first step in this research, a notice will be published in the Federal Register soliciting comments on the ways in which such an organization might be involved in the prohibited transaction exemption process.

ERISA confers massive responsibility on DOL with respect to regulation of the investment of funds by plan fiduciaries. The law defines very strictly "interested parties" and prohibits their involvement in certain investments. The amount of money subject to ERISA (50% of total NYSE underwritings in 1983, for example) and the dynamic growth of new financial instruments guarantees continuing pressure on DOL for timely issuances of rulings. OPWBP has made a conscious decision with respect to its sparse personnel resources to continue to stress the quality of output despite a continuously rising number of exemption applications received. The Forum heard much testimony on this subject. While the Department's work is respected for its professionalism, the delays are not compatible with the need in the "market place" for rapid financing. There is some evidence that financiers simply avoid ERISA funds as sources of money because of the perceived bureaucratic problems. There is too much money subject to ERISA ($900 thousand million - 25% of NYSE equity) to permit this condition to continue. Limiting timely investment possibilities of ERISA-covered funds will potentially damage their rate of return and, accordingly, the benefits to plan participants.

The Federal Register notice is intended to generate comments on several aspects of the SRO concept, including:

- How the SRO might be organized and financed, and whether existing organizations might play a role in its initial formulation.

- What costs and benefits would be associated with an SRO.

. How timing, composition and planning for an SRO should be structured.

4. Office of Pension Statistics

The Forum recommends that the Secretary create an Office of Pension Statistics within the Office which administers Title I so as to enable the Secretary, as the principal policymaker on retirement income within the Executive Branch, to understand and anticipate developments as they affect pension policy and to make appropriate reports, recommendations and policy initiatives to the Legislative and Executive branches.

> Section 513(a)(2) of ERISA authorizes and directs the Secretary of Labor to collect and analyze data relating to employee benefit plans and to report the findings to Congress and to the President. To fulfill this responsibility, the Forum concludes that a central source of statistical information should be established within the Department. The Office of Pension Statistics would rely on the information contained in the electronic data base.

5. OPWBP Culture

The Forum concludes that the requirements for administering Title I of ERISA necessitate a professional culture within OPWBP, and that accordingly the Secretary, whose capacity to organize is not restricted by ERISA, should take certain organizational steps (which are not suggested as being all-inclusive):

A. Rename OPWBP the PENSION & BENEFITS COMMISSION ("PBC"). The objective is to distinguish the PBC from other DOL agencies and to associate with the professionalism connoted by the Securities and Exchange Commission.

B. Designate the principal officer of the PBC as the Commissioner with the rank of Assistant Secretary and provide for the appointment by the Secretary of an Assistant Commissioner. The responsibilities of the executive office of the Commission require two political appointees: one to act as the chief executive officer and the other to have contact with Congressional committees, Executive Branch agencies and private sector groups. The chief operating officer of the PBC should have the title of Administrator and should be a career employee. Continue the practice of having the principal officer of PBC report directly to the Secretary.

C. Designate PBC as a separate entity for budgetary purposes.

6. Public Outreach and Assistance

The Forum urges the Secretary to devote resources for public outreach and assistance. The Forum believes that such a policy helps to protect beneficiaries, foster an attitude of voluntary compliance, and facilitate and make more effective the enforcement program.

> In a limited way, OPWBP has devoted resources to public assistance as a kind of "preventive maintenance" in the belief that helping the public reduces the cost of enforcement. This practice has been challenged in the past. It is the belief of the Forum that ERISA enforcement is facilitated by efforts to reach out to the public in such ways as explaining the operation of the law, assisting in the preparation of returns, and being available to answer technical questions. If the appropriateness of allocating resources to an outreach effort under ERISA continues to be questioned, the Forum urges the Secretary to propose legislation specifically authorizing such an activity.

7. Regulatory requirements

The Forum devoted a great deal of time to considering problems that can be grouped together under the category of regulatory requirements. In lieu of any proposal for statutory change, the Forum submits the following three recommendations to ameliorate the problem of regulatory requirements:

A. In lieu of repeal of §406(or any part thereof), the Forum would urge the Secretary to allocate resources and place priority on the expanded use of class exemptions under §408.

B. The Forum believes that if a good faith effort to evaluate information requirements (the Summary Annual Report, the Annual Report, the individual benefits statement, and other reporting requirements) is made by Executive Branch agencies, Congress would be willing to consider agency recommendations to revise the formats. Notwithstanding earlier studies, it is felt that agency commitment to assuring that beneficiaries receive appropriate information could induce Congressional committees to reconsider the reasonability of present requirements.

C. In evaluating the reporting and disclosure requirements, the Forum urges the Executive Branch agencies to recognize the unique problems of small business in complying with those requirements, and, so far as permitted by law, to make special provisions to ameliorate the burden on small business of such requirements.

POLICY

1. Presidential Task Force

Certain members of the Forum recommend that a Presidential Task Force be designated to study the interrelationship of pension equity and pension cost to both employers and taxpayers. Such a Task Force should be bipartisan and representative, and have a clearly defined scope of work. There is a serious unreality underlying much discussion about retirement income policies, specifically that this country can afford to support all good ideas. There must be a framework within which decisions can be made and priorities established.

> The study should contain specific recommendations about how to make the retirement system equitable without incurring costs that jeopardize the balance of the system. It is suggested that the President organize the Task Force through the Secretary of Labor with input from the IRS, PBGC and SSA.

2. National Retirement Income Policy

With the acknowledgment that national pension policy should not be construed to dictate individual pension decisions, certain Forum members recommend that Congress consider formulating an express National Retirement Income Policy; and that the policy be explicitly considered when making legislative and administrative decisions regarding the three components of retirement income: social security, employer retirement plans (ERISA) and savings.

The Forum heard testimony from several witnesses about the need for central policy leadership in the retirement income area and has determined that such a broad-based policy directive should come from the Congress.

3. Single Agency

Certain Forum participants endorse H.R. 3339, the bill introduced by Representatives John Erlenborn and William Clay, to consolidate the responsibility for carrying out the provisions of ERISA into a newly established single agency.

The agency, the Employee Benefit Administration (EBA), would be headed by a three-member Board of Directors consisting of a liaison officer from both the Labor and Treasury Departments and the Executive Director of the EBA who would serve as Chairman. The PBGC would retain its current corporate status within the EBA, and the PBGC's Board of Directors would be identical to that of the EBA.

Those participants believe that a single agency for ERISA administration would avoid duplication and inconsistencies frequently experienced under the current system.

4. Relationships with Other Executive Branch ERISA and Benefits Agencies.

Some Forum members recommend that the Secretary request the President to form an Interagency Employee Benefits Council to coordinate pension and welfare benefits information and activities among the different agencies.

Executive Order #12262, dated January 7, 1981, established an Interagency Employee Benefits Council under the leadership of the Secretary of Labor. The Council was to include, among others, the Departments of

Treasury, Justice, Commerce, and Health and Human Services, and a permanent secretariat to be provided by the Department of Labor. The Council would have had coordinating responsibilities with respect to information, inconsistencies and the development of short- and long-term policies as they affect the relationship among the agencies. The Order was not actively effective because it was signed in the last days of the Carter Administration and was repealed in 1982.

During the last four years, interagency coordination has been informal. Crises that have arisen have been handled by the Pension Policy Working Group of the Cabinet Council of Economic Affairs. A permanent Interagency Employee Benefits Council would have the ability to deal with issues before they become crises. It would also work in conjunction with any future single agency for ERISA administration to help achieve coordination with the many agencies which would not be included in the single agency.

FINAL
REPORT OF THE ERISA
ENFORCEMENT WORKING GROUP

July 30, 1984

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EXECUTIVE SUMMARY

For the last 4 months, a special Enforcement Working Group has been reviewing all aspects of the Department of Labor's enforcement activities under the Employee Retirement Income Security Act of 1974 (ERISA) to determine how successful the Department has been in meeting its responsibilities and to recommend improvements where deficiencies exist. Although the Department can point to many examples of successful ERISA enforcement, numerous problems were found in the areas of resource allocation, organizational structure and internal management.

We compared the resources available to meet the Department's enforcement responsibilities under ERISA with the resources available to other Federal enforcement agencies in meeting their responsibilities and concluded that at no time in the history of ERISA enforcement have sufficient resources been made available to fulfill the responsibilities given the Department. As a result of this lack of resources, the Department has been unable to maintain a level of credibility sufficient to create an impression within the employee benefit plan community that violations of criminal and civil law related to employee benefit plans are likely to be detected and corrected.

Structurally, the Working Group concluded that law enforcement responsibility for employee benefit plans is diffused both within the Department of Labor and within the Federal Government. Because of this division of authority, there is no one Federal enforcement voice speaking on employee benefit plans. As a result, in every area, from policy decisions to the conduct of specific investigations, the enforcement effort is not as effective as it should be and has suffered from a lack of coordination among the various responsible agencies.

Within the Office of Pension and Welfare Benefit Programs, serious management problems have been found to exist. The first step in curing these problems has already been taken by creating OPWBP as an independent agency within the Department. However, much remains to be done and the committee has made recommendations with respect to automated data processing, proper use of reports filed with the Federal Government, additional methods of enhancing enforcement, internal organization of the enforcement effort, training, recruitment, field evaluation, etc.

Finally, the Working Group considered whether a climate of enforcement exists within the Department and what elements are necessary to establish and enforce a Federal pension policy to effectively fulfill the promise of ERISA.

INTRODUCTION

On March 13, 1984, a special ERISA Enforcement Working Group was established by the Administrator of the Office of Pension and Welfare Benefit Programs (OPWBP) to review all aspects of the Department of Labor's (DOL) enforcement responsibilities under the Employee Retirement Income Security Act of 1974 (ERISA). All three DOL agencies to which the Secretary has delegated portions of his employee benefit plan enforcement responsibility were represented on the committee; the Office of Pension and Welfare Benefit Programs, the Office of the Solicitor, and the Office of the Inspector General. The primary goal of the committee was to present an overview of the Secretary's entire enforcement obligations under ERISA, determine where we have been in the past, where we are now, and what we should do in the future.

Because the mandate of this committee has been limited to the area of enforcement, no other areas of ERISA or national pension policy will be discussed. It should be recognized, however, that enforcement does not exist in a vacuum and that any national enforcement policy must be an integral part of an overall unified approach which considers all aspects of governmental involvement in the regulation of employee benefit plans.

In undertaking its activities, the committee reviewed past statements of Departmental ERISA policy and past evaluations and criticisms of the Department's ERISA enforcement efforts (both from within and without the Department of Labor), analyzed existing management and enforcement systems, reviewed past targeting and evaluations of targeting, reviewed past training programs and their evaluations, distributed a questionnaire dealing with targeting and training to the field, and interviewed representatives of other Federal enforcement agencies. As a result of this analysis, certain basic facts emerged which will be discussed in more detail in this report.

The main conclusion reached by the committee is that, despite many notable successes in the past, the Department's ERISA enforcement activities lack sufficient credibility both in the employee benefit plan world and in the executive and legislative branches of the federal government. This is primarily the result of a lack of commitment of sufficient resources to effectively establish credibility as well as of less than optimum use of the resources which have been allocated. As a result of inadequate resources, no matter what enforcement policies the Department pursued in the past, the results were always insufficient. Regardless of how well ERISA enforcement is structured for the future, unless adequate resources are provided, it will be impossible to implement the congressional policy contained in ERISA of protecting the interests of participants in private pension and welfare plans and their beneficiaries.

BACKGROUND

Throughout the 10 year history of ERISA, no consistent enforcement policy has been maintained beyond the tenure of the individual with primary responsibility for implementing it. At its inception, ERISA enforcement emphasized technical assistance and program education. Based on criticism of that policy, including a Science Management Corporation report of November 18, 1977, and a GAO report of September 28, 1978, enforcement policy was redirected to fiduciary investigations with an emphasis on large employee benefit plans. This policy in turn was criticized for placing insufficient emphasis on delinquent and deficient annual report filings (GAO Report, October 19, 1981 and Walsh Report, May 1, 1982) as well as for assigning insufficient priority to criminal investigations (Senate Labor Committee Report of February 23, 1982, Walsh Report, GAO Report of September 28, 1978) and placing insufficient emphasis on investigations of smaller plans (Walsh Report). In response to these criticisms, enforcement policy was redirected to greater involvement in criminal investigations, greater review of smaller plans, and consideration of ERISA violations other than fiduciary violations. This new policy, in turn, is now being criticized for lacking a clearly defined enforcement strategy (OIG recommendations of April 11, 1984) and for being too vague and broad, thus resulting in a lack of direction and consistency (GAO

Unofficial Comments of February 24, 1984). The structure of LMSA, litigation strategy, and interagency coordination have also been the subject of both internal and external criticism.

In the view of the committee, all of these reports and criticisms, while raising many valid issues, reinforce our basic conclusion that adequate resources have never been made available to the Department to adequately fulfill the Secretary's obligations under the Act. This basic conclusion was reinforced by our interviews with representatives of other agencies and an analysis of the resources of each compared with the universe it regulates. In addition to the resource question, however, the committee has found that support for investigative personnel, whether it be automated data processing capacity, training, targeting or technical assistance has been sadly lacking and that the Department has not fully used all potentially available enforcement remedies. Finally, and perhaps most important, there is a question of whether a proper enforcement climate exists within the Department of Labor to permit the vigorous enforcement of the laws currently entrusted to it. The balance of this report will describe the ERISA universe, the Secretary's obligations under ERISA, and the improvements which, in the committee's view, are necessary to provide the Department of Labor with a credible overall ERISA enforcement program.

PLAN UNIVERSE AND PERSONNEL RESOURCES

There are currently approximately 43,200 pension plans and 63,900 welfare plans each with more than 100 participants subject to the coverage of ERISA. In addition, excluding Keogh plans, there are 732,000 covered pension plans with fewer than 100 participants. Because insured welfare plans with fewer than 100 participants are not required to file reports, the exact number of such plans cannot be determined, but estimates range above four million. The amount of capital resources controlled by ERISA covered pension plans is now in excess of $900 billion and this total is anticipated to grow enormously over the next several years. How this money is controlled and invested will not only determine the retirement future of the majority of American citizens, but will also determine the way in which the United States will use its investment capital to rebuild itself to face the challenges of the next century.

To police this plan universe, OPWBP currently has a total of 175 investigators and auditors (although its budgeted ceiling is 223). According to the most recent available statistics, it now takes an OPWBP field investigator an average of 24.0 days to conduct a fiduciary investigation, an average of 84.9 days to conduct a criminal investigation and an average of 4.0 days to conduct an on-site targeting audit. Although Federal Banking

Regulatory Agencies differ from OPWBP in that thay license banking institutions, these agencies provide a basic for comparison because they, along with pension plans, regulate the primary sources of investment capital in the United States. These agencies examine all of their client financial institutions every 12 or 18 months. Financial institutions which are in poor shape are examined more frequently. If OPWBP were to apply the same principle to only those pension and welfare plans of more than 100 participants each, an attempt to simply conduct on-site targeting audits would require 428,400 staff days. If all pension plans were visited, it would take approximately 3 1/3 million staff days.

Viewing this example another way, if OPWBP were to conduct on-site targeting audits of the larger plans as well as only a 2 percent sample of the smaller plans every 12 months, approximately 2,600 investigators would be required. The fact that OPWBP does not currently have 2,600 investigators is one reason why it does not have the same impact on the employee benefit plan community as financial regulators have on the financial community.

Even if we audited these plans every 5 years, given the current average of 4 days for an on-site targeting audit, OPWBP would require 520 investigators. "Bad actor" plans would require more frequent attention and should be visited no less frequently than once every 2 years. If we assume that "bad actors" constitute approximately 5 percent of the large employee benefit plan community, this would require nearly 60 additional investigators. Currently, approximately 20 percent of all on-site targeting audits uncover sufficient reason to convert the audit to a fiduciary investigation and of these, approximately 4 percent are converted to criminal investigations. Fiduciary and criminal investigations take approximately 24 and 84.9 days, respectively to complete. If these numbers hold true in the above example, a 5 year investigative cycle would require approximately 2,000 investigators.

It should be borne in mind that the above model does not consider investigative time that would be required to undertake special enforcement projects and special targeting initiatives or time required to respond to participant complaints and leads from the media and from other agencies. Also not considered is the fact that if the Department were to have an effective delinquency and deficiency reporting program, on-site follow-up visits would be required to maintain its credibility. Finally, in addition to the number of investigators necessary to fully monitor the ERISA universe, sufficient supervisory and clerical personnel would also be required. In the committee's view, while a one-to-five ratio of supervisors to investigators would be desirable, we believe the ratio could go as high as one-to-six or one-to-seven and still permit adequate guidance and review.

Against this background, a review of OPWBP's actual production for FY 1984 (taking 6 months of actual experience and projecting it through the rest of the year) reveals that the Department will conduct only 750 fiduciary investigations, 1,420 on-site targeting audits, and 30 criminal investigations. At this rate, it would take 55 years to audit all large plans and a 2 percent sample of small plans. It is no wonder that the employee benefit plan community considers the risk of a Department of Labor audit insignificant.

ERISA ENFORCEMENT OBLIGATIONS OF THE SECRETARY

Section 2(b) of ERISA, 29 U.S.C. Section 1002(b), declares the policy interests to be protected by the Secretary of Labor under the Act:

> It is hereby declared to be the policy of this Act to protect interstate commerce and the interests of participants in employee benefit plans and their beneficiaries, by requiring the disclosure and reporting to participants and beneficiaries of financial and other information with respect thereto, by establishing standards of conduct, responsibility, and obligation for fiduciaries of employee benefit plans, and by providing for appropriate remedies, sanctions, and ready access to the Federal courts.

Certain other responsibilities have been assigned to other agencies. For example, the Internal Revenue Service (IRS) is responsible for protecting the Federal taxing power and the Pension Benefit Guaranty Corporation (PBGC) is responsible for plan termination insurance. Reorganization Plan No. 4 of 1978, which was approved by Congress on August 10, 1978, allocates other responsibilities to the Internal Revenue Service and the Secretary of Labor. Pursuant to that reorganization, the IRS has primary responsibility for matters relating to parts II (participation and vesting) and III (funding) of subtitle B of title 1 of ERISA. The Secretary of Labor has been given primary responsibility for part IV (fiduciary responsibility) pursuant to that agreement. In addition to the responsibility allocated by the Reorganization Plan, the Secretary retained responsibility for enforcement of part I (reporting and disclosure) and part V (enforcement).

Pursuant to a memorandum of understanding with the Department of Justice, the Secretary has delegated certain criminal enforcement authority, particularly that contained in ERISA section 411, 29 U.S.C. section 1111 and ERISA section 511, 29 U.S.C. section 1141, to the Department of Justice. In addition, that same memorandum states, subject to specific arrangements between the Department of Labor and the Department of Justice, that the Department of Justice will be responsible for investigating all matters arising under 18 U.S.C. sections 664, 1027, and 1954, even though these three sections expressly relate only to ERISA covered employee benefit plans. However, the Department may obtain a delegation from the Justice Department to investigate such crimes on a case-by-case basis. The only primary criminal investigative authority retained by the Secretary of Labor with respect to employee benefit plans is that contained in section 501 of ERISA, 29 U.S.C. section 1131, which creates a misdemeanor offense for willfully filing a false report under part 1 of title 1 of ERISA.

Pursuant to ERISA section 502(j), 29 U.S.C. section 1132(j), attorneys appointed by the Secretary may represent the Secretary in all civil litigation subject to the direction and control of the Attorney General. This direction and control have been memorialized in a memorandum of understanding with the Department of Justice, dated February 5, 1975, pursuant to which, subject to specific case-by-case clearance, Departmental attorneys represent the Secretary in civil litigation unless the case raises significant issues concerning the validity or construction of statutes or important governmental regulatory schemes (i.e., a significant Constitutional issue) or the case has a significant impact on the Government as a whole or on agencies or programs other than those of the Department of Labor. Significantly, these exceptions only apply to the question of who will exercise primary litigative responsibility and do not deal with the question of whether a suit should be filed by the Department in the first place.

Finally, pursuant to section 506 of ERISA, 29 U.S.C. section 1136, the Secretary has authority to enter into agreements with other agencies for the purpose of performing his duties under title 1 of ERISA as well as for the purpose of avoiding unnecessary expense and duplication of functions among Government agencies. To date, agreements have been entered into not only with the Department of Justice (as discussed above) but with the Federal Banking Regulatory Agencies, the Internal Revenue Service, and the Department's own Office of the Inspector General.

In addition to these express responsibilities arising from ERISA, the Secretary has a role to play in providing assistance to Department of Justice Strike Forces in certain areas dealing with employee benefit plans (primarily violations of 18 U.S.C. sections 664, 1954 and 1027). Currently, the Secretary fulfills this responsibility through the Office of the Inspector General with respect to organized crime.

In addition to the enforcement authority of the Department of Labor, the Internal Revenue Service and the Department of Justice, other Federal agencies, including the Securities and Exchange Commission, the Federal Banking Regulatory Agencies, and the Pension Benefit Guaranty Corporation, also have responsibilities with respect to employee benefit plans. In short, there is no one voice which speaks on enforcement aspects of Federal pension policy in the United States.[1]

ENFORCEMENT GOALS

At least one meeting of the committee was devoted to consideration of the goals of an effective enforcement program. The participants felt that the number one priority of any effective ERISA enforcement program must be a systematic program of criminal and civil investigation designed to protect the assets of employee benefit plans. However, while the most important, this is clearly not the only goal that a credible enforcement program must achieve. Recognition was given to the fact that any balanced program requires several ingredients beyond the investigation and prosecution of fiduciary and criminal cases. Among other components of such a program are the enforcement of other provisions of title 1 of ERISA, involvement in benefit dispute cases, technical assistance matters, referrals to other agencies and public disclosure. The committee believes that a mix of all of these functions is important for several reasons, not the least of which is to establish the credibility of the program and to provide a deterrent to potential ERISA violations in the employee benefit plan community.

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[1] The preceding discussion has been limited to the Secretary's obligations only insofar as they specifically relate to enforcement. Thus, other important ERISA functions entrusted to the Secretary of Labor, such as his Chairmanship of the Pension Benefit Guaranty Corporation, have not been discussed.

Previous enforcement policy has been criticized for not doing everything that ERISA authorized the Secretary to do. As has been discussed previously, however, at no point in the history of ERISA enforcement have sufficient resources ever been made available to the Department to successfully do the job. Regardless how large an enhancement is eventually obtained by OPWBP, it is unlikely that sufficient investigative resources will ever be available to completely monitor the entire employee benefit plan community in the same manner as, for example, the banking regulatory agencies monitor the regulated banks. Because of this simple fact, it is necessary to establish rational priorities which, by their very definition, will either exclude certain matters or give them a lesser priority. In establishing such priorities, the committee believes that the Department must enhance and maintain a strong deterrent effect on those who would violate the law and thus enhance the credibility of OPWBP as an enforcement agency. In order to do this, we believe that any case selection process, regardless of the specific targeting techniques used, should include four main components.

The first component is to insure that a random audit program exists which targets plans of all types and in all locations. The purpose of this approach is to create the impression that no plan fiduciary is completely safe from OPWBP investigation, even if the chance of such investigation is small. This approach is similar to that used by the IRS which, although it concentrates on certain key areas, does devote a certain amount of resources to random audits so that no tax filer can consider himself completely immune from audit.

The second factor to be considered is that any rational enforcement policy should concentrate on the "bad actors"; those who through their past conduct have shown that they require more attention than the world at large. OPWBP area offices may already have much information on who the bad actors are in their respective communities. In addition, through contact with other law enforcement agencies, the media, and by listening to participant complaints, new problem areas are always emerging. These areas and issues must be dealt with and will, on an on-going basis, always require considerable investigative effort.

The third component should be concentration on special projects designed to achieve a specific enforcement goal. One past project in this area was the OPWBP initiative to monitor compliance with two previously issued class exemptions of the Department of Labor. A current effort is the soft-dollar investigative project now being undertaken. With such projects, it is desirable to give as much advance notice to the field as possible so that rational planning can include an allocation of resources over a sufficient period of time to avoid disruption of normal operations.

The fourth concern should be the protection of the greatest number of participants given the resources available to do the job.

There are other goals which must also be included in any effective enforcement process. With respect to OPWBP, these goals would include:

- o obtaining restitution on behalf of employee benefit plans.
- o removing harmful individuals from contact with such plans (both civil and criminal methods should be used to effectuate such removal).
- o establishing legal precedent for the guidance of the public.
- o enlisting the assistance of others, such as plan accountants, in our enforcement efforts.
- o encouraging private initiative as contemplated by section 502 of ERISA (this would include not only encouraging more private lawsuits, but would also encourage greater awareness by plan participants of their rights and increase their ability to obtain meaningful information about their plans)

- public assistance
- promotion of legislative and public awareness of OPWBP's enforcement efforts
- participating in the process of obtaining legislative and regulatory solutions to enforcement problems

All of these are components of what the committee believes will be an effective overall enforcement strategy. How these factors should be combined will, among other things, depend on the resources available to the agency at any given time and the policy initiatives the OPWBP Administrator may wish to pursue. The ordering of these priorities into a strategy document is an occurrence which we believe should take place on an annual basis and the priorities should not remain static from year to year. Given the current restructuring which gives OPWBP line as well as program authority, annual priorities should be combined with time allocation standards in the document to provide a unified annual plan.

With respect to other enforcement activities, such as benefit dispute cases, participant complaints, etc., the committee believes that, although important, they do not warrant the expenditure of an investigator's time. Rather, we recommend a return to the system of employment of law students and paralegals for these purposes. During the time law students were present in area offices, they provided a very efficient and effective means of dealing with these issues and did so at a very low cost. Additionally, by possessing the capacity to provide direct service to plan participants and complainants, the presence of law students enhanced the interaction between area offices and plan participants and thus became a good source of intelligence and potential contacts for the development of fiduciary and criminal cases.

Technical assistance, while not as important (in terms of time spent) as it was in the early days of ERISA, is still an important function for OPWBP to undertake, primarily because of its impact on the public's perception of OPWBP. When possible, this function should be undertaken primarily by the National Office and should include the production and distribution of informative material relating to ongoing ERISA matters. Additionally, speakers should be made available, as appropriate, to address various issues. In most cases, this activity should be performed by the National Office or the larger area offices and should not be allowed to detract from investigative time. In certain situations, however, technical assistance on a local level will be required and, provided it does not substantially detract from investigative time, should be provided. In such cases, however, the local offices should rely on the National Office for preparation of materials, etc.

CRIMINAL LAW ENFORCEMENT

Prior to 1981, the Department's primary role with respect to the detection and prosecution of criminal violations relating to employee benefit plans was through its participation in Organized Crime Strike Forces of the Department of Justice. Originally, this participation consisted of the assignment of LMSA investigators to work directly with Strike Forces; later this function was performed by the Office of the Inspector General. Other than involvement with the Strike Forces, DOL's activity with respect to criminal law was limited to referral to Justice of evidence of potential violations and, on a relatively infrequent basis, the investigation of criminal matters pursuant to delegation from the Department of Justice.

Beginning in 1981, the Department's enforcement priorities under ERISA were changed to give a higher priority to the detection and prosecution of criminal violations relating to employee benefit plans. Primarily, these consisted of violations of sections 664, 1027, and 1954 of Title 18 of the U.S. Code, although violation of other laws, such as mail fraud, Taft-Hartley, and conspiracy were also investigated. Training was provided for all field personnel in the conduct of criminal investigations and each of the six LMSA regions established its own procedures for processing criminal cases.

The committee believes that OPWBP should maintain a strong involvement in the detection and prosecution of criminal violations of Federal law relating to employee benefit plans.

While relations between Department of Labor field offices and various United States Attorneys have generally been good, the committee recommends that the Department begin negotiations with the Department of Justice to revise the 1975 memorandum of understanding concerning criminal investigations. In our view, the arrangement between the Department of Justice and the Department of Labor in the area of criminal investigations must be one of cooperation and not one of total delegation of formal responsibility by the Department to the Department of Justice. While we do not believe that the Department should, itself, have final authority on whether to bring a criminal case (as it does with respect to civil cases), we believe the Department should have a greater consultative role with the Department of Justice in making such determinations.

At present, at least one office within the Department of Justice has raised the question of whether the Department has an independent grant of authority to investigate Title 18 crimes related to employee benefit plans. Legislation is now pending in Congress to remove any ambiguity which may exist in this area by expressly conferring such authority on the Department of Labor. Until such a bill is passed, however, in order to avoid ambiguity and to deter legal challenges, the committee recommends that any new memorandum of understanding with the Department of Justice concerning the detection and prosecution of criminal violations contain an express general delegation to the Secretary of Labor to investigate potential criminal violations of Title 18 laws relating to employee benefit plans. In other words, rather than the existing case by case delegation which now exists, the committee recommends a delegation allowing the Secretary to use his own discretion in deciding which criminal violations relating to employee benefit plans to pursue and how to pursue them. In addition, a new memorandum should provide a process whereby, if prosecution is declined by a local United States Attorney or Strike Force, the matter may be elevated to the National level for consideration by a joint DOL/DOJ committee specifically constituted to make such prosecutorial decisions. A procedure along these lines would give the Department unquestioned investigative authority with respect to employee benefit plan related criminal investigations and would give the Department more equal standing with Justice in deciding what matters should be investigated and prosecuted.

Internally, experience over the last year has shown that most OPWBP criminal investigations have been generated either as an off-shoot of a civil investigation or through a complainant coming to an OPWBP office. In the future, the other leading source of cases should be review of Forms 5500 filed by employee benefit plans or, in the alternative, willful concealment with respect to such forms. For this reason, OPWBP personnel are in the best position to initially become aware of potentially criminal conduct. Therefore, in the first instance, OPWBP should decide how to proceed with a criminal investigation. The choices would be:

- o seeking a delegation from DOJ or simply working the case (depending on whether the memorandum of understanding with the Department of Justice is revised).
- c referral to either OIG, the FBI, LMSE or another agency authorized to investigate criminal matters.
- o a joint criminal investigation using the resources of more than one investigative agency.

For most criminal investigations, the choice of forum should be relatively easy. If the matter is already being worked by a strike force, or concerns an entity targeted by a strike force, referral to either the Strike Force or OIG is appropriate.[2/]

If the matter is an isolated instance which we lack the resources to deal with properly, a referral to the FBI may be appropriate. If a labor union is considerably more involved than an employee benefit plan, LMSE should be the lead agency. Because of those cases however, which may not be quite as clear cut, we strongly recommend that regular periodic meetings, at the senior staff level, be held in Washington with representatives of OPWBP, OIG, LMSE and SOL. These meetings, with respect to criminal matters, would serve several purposes. First, they would provide a forum to resolve problems of coordination and jurisdiction. Second, they would serve as a clearing house of information to avoid duplication of effort and permit legitimate sharing of relevant information. Third, at a time when LMSA is splitting into its component parts, it would maintain the lines of communication and contact so as to further the investigative interests of both agencies.

Within OPWBP, the committee sees no reason why parallel criminal and civil proceedings cannot proceed simultaneously

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[2/] The committee has not considered whether a criminal investigative function should remain in the Office of the Inspector General or be transferred to another agency. For purposes of this discussion, we have simply assumed that the status quo will be maintained.

in appropriate situations. On a case by case basis, it would be the responsibility of managers and supervisors to determine whether a criminal, civil or both cases should receive priority. As a basic rule of thumb, in a situation where plan assets are being diverted or are at risk, the primary concern should be that proceeding most likely to result in immediate removal of the person and reduction of the danger. Ordinarily, this would consist of a civil remedy. Conversely, in a situation where the individual is no longer in a position of responsibility, criminal investigation should take priority. At this time, OPWBP does not have the resources to create separate tracks composed of criminal and civil investigators. However, as discussed in the training section of this Report, we do believe that certain investigators should be given specialized training in criminal matters so as to enable them to be either lead investigators in complicated cases or resource personnel for other investigators in their office. Ultimately, depending on what enhancement OPWBP obtains, more specialization may be appropriate.

We believe that separate supervisory channels within OPWBP should be maintained for criminal cases to avoid any possibility of taint through improper disclosure of grand jury material or through improper use of civil administrative subpoena power. To this end, OPWBP's Office of Enforcement should designate one individual to act as criminal case coordinator in Washington. This person would be responsible for criminal case review at the National level and would play no role whatsoever in the day to day review of related civil cases reaching the Office of Enforcement. This individual would be included on all Rule 6(e) F.R. Crim. P. disclosure lists and would be aware of all major OPWBP criminal investigations in progress.

At the area office level, no office should have fewer than two supervisors (at least one area administrator and one track supervisor). In those situations where criminal investigations are contemplated or in progress, one of the two supervisors should be fully divorced from any involvement in the criminal case. It is this supervisor who would then be responsible for any civil matters which may arise out of the same fact situation. In smaller offices, where such a relationship may be unworkable, a manager from a large office should be assigned to supervise one or the other of the cases.

Even more so than in civil matters, a criminal case requires close and constant contact between the investigator and the prosecuting attorney in order to assure that all steps of his or her investigation are consistent with the U.S. Attorney's view on how the case should be handled. Periodic meetings with the AUSA should be held to discuss all pending criminal matters and OPWBP supervisors of the criminal cases, should be involved in those meetings. The purpose of such meetings is threefold. First, if a case has no prosecutorial potential, regardless whether a criminal offense may have occurred, the sooner OPWBP can obtain that information from a U.S. Attorney the sooner it can stop wasting resources on a futile investigation and devote them to more productive matters. Second, to the extent an assistant U.S. Attorney is actively involved in a matter from its inception, that person is more likely to be committed to bringing the case when the investigation is completed. Third, the guidance of an experienced attorney with respect to matters such as evidence and elements of proof will be extremely useful to the investigator in any but the simplest of cases.

RECOMMENDATIONS TO ENHANCE CIVIL ENFORCEMENT

Under the current investigative structure, OPWBP relies primarily on review of 5500s, complaints, the media and referrals from other agencies to develop most of its cases for investigation. When violations are found, the main enforcement tools currently used are voluntary compliance, civil litigation and referral to the Internal Revenue Service. In the committee's view, more can be accomplished in obtaining the assistance of others in OPWBP's investigative efforts and in assuring enforcement in situations where violations are found. Three methods of enhancing OPWBP's civil enforcement effort are discussed below.

A. OBTAINING THE ENFORCEMENT ASSISTANCE OF PUBLIC ACCOUNTANTS

One specific project discussed in some detail by the committee was whether public accountants who are now required to audit employee benefit plans on an annual basis can be required to report certain adverse findings directly to the Labor Department. Several precedents have been suggested for OPWBP's consideration with respect to such a program, including the SEC's Rule 2(e) and GAO Circular A-102. Attachment P of that circular establishes audit requirements for state and local governments, among others, who receive Federal assistance. Guideline number 9 states:

> if the auditor becomes aware of irregularities in the recipient organization, the auditor shall promptly notify the cognizant [Federal] agency and recipient management officials above the level of involvement. Irregularities include such matters as conflicts of interest, falsification of records or reports, and misappropriation of funds or other assets.

Although our situation is not exactly the same, to the best of our knowledge, no legal impediment exists to keep the Department from requiring similar reporting to it by accountants who audit employee benefit plans.

At present, an accountant's report is already required by ERISA for plans with more than 100 participants and often such plans pay large amounts of money to obtain such reports. The committee's proposal is simply a specific format for that report combined with a requirement that certain significant events uncovered during an audit be reported to the Department of Labor in a form useable by it. OIG and OPWBP field personnel working with the committee have prepared a more detailed analysis of this proposal which is appended to this report as Attachment 1.

This staff analysis includes examples of information which could be required through such a procedure, including whether a plan has invested over 25% of its assets in any one security, debt, mortgage, piece of real estate or other property; whether a plan holds more than 50 individual whole life insurance policies on the lives of its participants, and whether a plan has mailed a copy of its summary annual report to each plan participant during the preceding year. A form can easily be devised to be included with the Form 5500 which would be signed and certified by an accountant and contain simple yes/no answers to these and other specifically designated reportable events. By a computer scan of such returns, OPWBP can have notice of those plans which deserve further scrutiny. At the very least, the triggering of an item in this report should cause an investigator to personally review the entire accountant's report which has been filed with the Form 5500.

The Securities and Exchange Commission, in its Regulation 2(e), currently has a procedure for imposing sanctions on accountants who file inaccurate or incomplete statements. We have been advised by SOL that, pursuant to duly promulgated regulations, a similar system can be employed by the Department of Labor to enforce accountant reliability with respect to certifications on Forms 5500s.

Among the sanctions which can be employed by the Department against accountants who breach their obligations is the disbarment of those accountants who have filed misleading or inaccurate reports from certifying any additional reports to the Department of Labor pursuant to ERISA. Such a disbarment proceeding would require specified administrative procedures within the Department to assure that any accountant against whom sanctions are contemplated is given certain due process rights. These procedures would have to be specified in Departmental regulations.

In addition, again pursuant to regulation, a requirement can be imposed that the summary annual report, which is now distributed to all participants, include a copy of any specified negative findings found by an accountant in his audit of a plan. This can be done either through distributing a copy of the attachment filed with the Form 5500 or by requiring a special narrative.[3/]

[3/] In response to recent GAO criticism of the Department's efforts to detect plans maintaining insufficient actuarial

(Footnote Continued)

The committee recommends that discussions begin both internally and with the general public on whether such a project, which would require the active assistance of public accountants, would be worth the administrative burden of implementation. To this end, we recommend that excerpts of the report on this project prepared for the task force be referred to the Enforcement Working Group of the National Pension Forum of the ERISA Advisory Council for formal discussion. That group, which includes representatives of the accounting profession, would provide a good forum for bringing this proposal to the attention of the general public and, in particular, to the attention of the leading voices in the accounting field. Their support will be necessary if a program along these lines is to be successful.

In addition, OPWBP staff should begin the process of preparing a checklist of reportable events which would require an accountant's certification. The purpose of this checklist would be to prepare a form which could eventually be included on the Form 5500 and which would be capable of a

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(Footnote Continued)
data, the committee recommends that a similar inquiry be instituted to determine if an equivalent program can be devised for plan actuaries which would result in a requirement that they report to the Department on those situations where inadequate records make it impossible for them to prepare reasonable projections.

rapid computer scan in order to identify matters requiring immediate attention.

B. REFERRALS TO THE IRS FOR IMPOSITION OF AN EXCISE TAX

With the enactment of ERISA, the Internal Revenue Service was given authority to impose an excise tax on certain persons who engage in prohibited transactions with tax qualified employee benefit plans. Prohibitions against prohibited transactions were also enacted in section 406 of ERISA, 29 USC section 1136, and the Department was given enforcement authority including undoing the transaction, obtaining injunctive relief, and providing restitution to the affected employee benefit plan. However, the authority to impose an excise tax in cases involving tax qualified plans resides solely with the Internal Revenue Service.

In 1983, in an attempt to streamline enforcement of section 406, the Department entered into an agreement with the Internal Revenue Service which provided for transmission to IRS by DOL of certain cases which DOL felt were appropriate candidates for imposition of an excise tax.

According to statistics provided by the OPWBP Office of Enforcement (OE), for the period of June 1, 1983 to May 2, 1984, 390 cases were sent to the Internal Revenue Service after OPWBP investigation. The overwhelming majority of these investigations were referred for the purpose of imposing an excise tax as a result of an OPWBP finding that a prohibited transaction had occurred. According to OPWBP's agreement with the Service, the IRS is committed to taking action on appropriately referred cases and the Department has agreed to provide its investigative files for purposes of enforcement and/or proof.

During the time the agreement has been in effect, 123 referrals involving prohibited transactions have been closed by the IRS. Of these, 107 were closed with no action and only 16 resulted in the imposition of a tax. Thus, of the prohibited transaction cases concluded, over 6½ times as many were closed with no action as were resolved by the imposition of a tax. As of the date of OE's report, 267 referrals remained open.

No follow-up has been done by OPWBP to determine why so many "gift-wrapped" cases have been closed without action by the Service. Based on these results, DOL's agreement with the IRS does not appear to be working as planned. While the committee has not had time to determine the exact nature of the problem, we believe it should be identified and corrected at the earliest possible time. If the problem cannot be resolved at the operational level, we believe it is important enough to be referred to senior level policy officials.

C. DEPARTMENTAL IMPOSITION OF A CIVIL PENALTY PURSUANT TO ERISA SECTION 502(i)

The only cases which can be referred to the IRS for imposition of an excise tax are cases which involve tax qualified pension plans. With respect to all ERISA covered welfare plans, the Department has direct authority to impose a civil penalty. This authority is contained in section 502(i) and provides a penalty in an amount not to exceed five percent of the amount of the transaction. In the event the transaction is not corrected within ninety days after notice, a penalty may be assessed in an amount not more than 100% of the transaction. To date, the Secretary of Labor has never imposed a civil penalty under this section. In the view of the Office of the Solicitor, prior to use of this provision, regulations must be propounded pursuant to which the penalty is assessed and which would assure that anyone against whom it is assessed is afforded certain administrative due process rights. Although early consideration was given to the promulgation of such regulations, none have ever been written.

In the view of the committee, imposition of civil penalties pursuant to 502(i) is a useful tool which should be employed by the Department. To allow its use, we recommend that appropriate implementing regulations be immediately developed and issued.

The only objection raised with respect to this remedy is the possibility that assessing such a penalty might entail a greater administrative burden on the Department than the effectiveness of the remedy would warrant. However, in our interviews with key personnel of other agencies, primarily the Federal Reserve Board, the Office of the Comptroller of Currency, and the Bureau of Motor Carrier Safety of the Federal Highway Administration, we discovered that such civil penalties are common and useful enforcement tools. In none of these agencies was any administrative burden imposed which exceeded the enforcement value of the remedy. In these agencies, it should be noted, the imposition of civil penalties is not considered to be primarily a revenue raising device, but rather a method of assuring compliance with the law.

While we recognize that OPWBP's circumstances may differ from other agencies, a similar penalty imposed upon parties in interest in situations involving non-qualified plans where prohibited transactions are found could be an effective enforcement tool and should be utilized by DOL. In cases where losses have also resulted, we are aware of no reason why imposing a civil penalty cannot be used in conjunction with other remedies seeking restitution and additional appropriate relief. As is done by other agencies with authority to impose civil penalties, OPWBP should retain discretion to waive or reduce such penalties in appropriate cases in order to maintain leverage to obtain compliance.

OPWBP RELATIONSHIP WITH LITIGATING ATTORNEYS

In our review of the investigative structures of other agencies, it quickly became apparent that those agencies which enjoy the best reputation as enforcement agencies, such as the Department of Justice Strike Forces and the Securities and Exchange Commission, all have close day to day involvement between investigators and attorneys during all stages of the development and prosecution of major cases. The committee believes a close relationship between OPWBP and its attorneys to be imperative if OPWBP is to become a credible enforcement agency. We have considered four options to improve the existing relationship.

The first option, which would be difficult to implement within the existing structure of the Department of Labor, would be to allow OPWBP to obtain its own lawyers pursuant to specially delegated schedule A hiring authority. Independent agencies, such as the FTC and the SEC function along these lines. This would be the most efficient way to accommodate joint investigative teams of attorneys and investigators under the sole direction of the Administrator, OPWBP.

However, the Department of Labor differs from agencies like the SEC and the FTC in that the Secretary of Labor is responsible for numerous, vastly different programs which bear no functional relationship to each other. In order to maintain some sense of consistency in the legal advice given to the Secretary, the entire legal arm of the Department has been entrusted to one agency i.e., the Office of the Solicitor, and therefore there is one lawyer i.e., the Solicitor of Labor, who represents the Secretary in all matters. If each agency within the Department were to have its own lawyers, different, and possibly contrary, legal positions would be presented to the Secretary and he would be put in the difficult position of having to make legal decisions based on conflicting advice from different lawyers. Therefore, strong policy reasons, based on the need for consistency and a common legal viewpoint, argue in favor of having the entire legal arm of the agency centralized within one office.

The committee is thus faced with a dilemma. It believes that the optimum structure for ERISA enforcement would be to have attorneys working side by side with investigators under the direction of the Administrator, OPWBP. On the other hand, within the Department of Labor, there are strong and compelling policy reasons which dictate the maintenance of the current structure of a separate Solicitor of Labor to whom all lawyers within the Department report. Because of these conflicting policy goals, the committee does not believe it is in a position to recommend this option.

A second option would be for OPWBP to designate certain investigations as major or complex, thus requiring the ongoing assistance of an attorney. In these situations, a specific request would be made to SOL for the assignment of an attorney. That attorney would, as part of his or her normal duties in SOL, be on call to assist the investigators throughout the conduct of the investigation. This would include taking administrative depositions, interviewing witnesses, reviewing documents and engaging in other forms of investigative discovery. This same team approach would continue once the civil law suit was filed. The investigator would be an active participant in the ongoing litigation process and would assist, as necessary, in post-filing discovery. Together, both investigator and attorney would be familiar with the case at all steps and each would benefit by the presence of the other throughout the process.

A third option would be to designate specific lawyers to individual area offices as "legal advisors" to those offices. These attorneys would periodically meet with area office personnel to discuss pending cases, issues and legal procedures. By having an attorney "on call", investigative problems, as they arise, can be discussed and appropriately dealt with. This option would not necessarily have an attorney side by side with the investigators on major investigations, but would provide a resource person who would be available to answer questions as they come up and provide sufficient legal direction to allow each area office to avoid false starts and produce better investigations.

A fourth option would be to establish a process of periodic meetings between representatives of SOL and OPWBP at the appropriate organizational level for the purpose of reviewing all major pending investigative and litigative matters. Through this forum, major investigative and litigation issues can be discussed at length and, to the extent necessary, appropriate support personnel can be assigned to deal with specific issues. While this option alone would not achieve the desired goal of a joint attorney-investigator enforcement effort, it would at least facilitate communication about enforcement matters and provide some direction to the individuals actually doing the investigation. If such an option is employed, it should be made a specific element of the performance standards of both SOL and OPWBP so that it is given the priority it deserves and does not get ignored or de-emphasized in the face of other pressing day to day matters.

The last three options are not mutually exclusive and, to a ~~greater or~~ lesser extent, can all be implemented simultaneously if the Solicitor's Office has sufficient resources. The goal of all three, as well as the goal of providing Schedule A hiring authority, is to increase the availability of legal assistance during the investigatory process. With this goal in mind, any other arrangement which increases attorney participation in the investigative process would be welcomed by the Committee.

STRUCTURE AND MATERIAL RESOURCES

A. AUTOMATED DATA PROCESSING

No area better typifies the problems facing OPWBP than those caused by its lack of a functioning ADP system. The inability to retrieve timely information from Forms 5500, the failure to establish credible delinquency and deficiency programs, the lack of a centralized functioning intelligence file and the absence of effective case management and monitoring systems can all be traced to the fact that OPWBP does not have a currently functioning ADP program. No single enhancement, in our view, can do more to restore the credibility of ERISA enforcement than the proper installation and use of a state of the art ADP system.

In order to deal with these issues, the committee contracted with the MITRE Corporation to prepare a concept level report on the data processing options available to meet the Department's enforcement needs under ERISA and the cost of each option. A copy of MITRE's Technical Memorandum is appended to this report as Attachment 2. After reviewing

OPWBP's current operations and discussing its needs, MITRE prepared four options; ranging from minimally acceptable to the maximum desirable. Each of these options contained numerous components and parts of each option can be combined into a total system.

Upon receipt of the MITRE report, it was referred for technical review to OPWBP staff. The staff analysis and recommendations are appended to this report as Attachment 3. Basically, the staff concluded that MITRE's third option is the optimum in terms of desirability balanced by cost, but amended that option to include (1) use of a shared mainframe rather than purchase of separate hardware, (2) use of nondedicated communication lines rather than separate lines and (3) input of less historical data into the system than contemplated by MITRE. All three of these modifications are designed to reduce the cost of MITRE's third option to an estimated $11¼ million over an eight year life cycle. The committee agrees with this recommendation of its technical staff and urges its implementation as soon as feasible.

While the system selected may seem expensive, we are aware of no other way to credibly fulfill the Secretary's obligations under ERISA. To put its cost into perspective, at the present time the Department is paying over $2 million a year to the Internal Revenue Service for partial data entry from Forms 5500. In addition to that sum, an additional one million dollars a year is being spent in microfiching 5500s. Assuming no increase in cost whatsoever over the next eight years this, in and of itself, would be an expenditure of $24 million to maintain a system which all OPWBP personnel presently consider to be unworkable. As opposed to this, through a state of the art system under OPWBP control, we can achieve the following desirable results.

The first and most important result to be obtained would be prompt entry of all data filed with the Federal Government on Forms 5500. Upon completion of the contemplated conversion to an electronic filing system, the process should be even quicker and less expensive. Once such forms are received and the data contained in them entered into the system, OPWBP will be in a position to effectively implement an on-going delinquency and deficiency enforcement program. Such a program is the keystone of any credible enforcement effort just as the monitoring of a tax return is the keystone of the IRS's successful revenue collection efforts. Based on a credible program of this nature, OPWBP will have a wealth of current material from which it can undertake significant computer targeting projects in areas of administrative costs, service providers, suspect transactions, and other matters which are currently beyond its capability. OPWBP would also have a system which would allow each area office to scan its own plan universe so as to implement locally designed targeting initiatives.

Additionally, such a system would allow OPWBP, for the first time, to maintain a centralized intelligence file whereby the information received in recent years, as well as the information currently being received, can be made available to anyone within the program who needs it. At the present time, most "institutional memory" within the program relies on the recollections of specific individuals. No area office has access to the contents of any other area office's intelligence files nor is it aware of the contents of reports of investigation prepared by other offices. By electronically making this information available, each office will be able to better research its own potential cases, and the National Office will be able to more effectively monitor and predict trends of potential abuse in the employee benefit plan community. This kind of capability would allow the Department's enforcement efforts to become more active rather than merely consisting, as is so often now the case, of a passive response to what may be read in the newspaper.

Finally, through the electronic mail and case management capabilities of such a system, management would be tremendously enhanced at both the National Office, and area office levels through establishment of an effective method of tracking cases to avoid statute of limitations and other problems that now plague our enforcement program. A state of the art system, such as discussed in the MITRE report and recommended by OPWBP's technical staff, is an indispensable way of demonstrating whether the Department is serious about becoming a credible law enforcement agency or not.

B. FORMS 5500.

In theory, Forms 5500 filed by employee benefit plans with the Internal Revenue Service and the Department of Labor should be the primary source for initiating investigations in any coherent ERISA enforcement policy. If properly used, Forms 5500 would provide an accurate data base of the entire plan universe, disclose relevant financial information about each plan, its service providers and expenses and, through properly designed targeting programs, direct enforcement efforts into the areas most useful to achieving program goals. At the present time, however, Department use of Forms 5500 does not achieve any of these results. In fact, with the exception of manual review by field personnel, they provide very little use in targeting plans for investigation.

One major deficiency with the Department's use of Forms 5500 arises from the fact that they are not received by the Department of Labor quickly enough. According to current practice, a plan is not required to file a Form 5500 until seven months after the year reported on has ended. The report is then filed with the Internal Revenue Service. If the report is in perfect condition (i.e., properly filled out and signed) it will take the IRS anywhere from three to five months to key-punch certain minimal data and make the computer tape available to the Department of Labor. An additional two to three months is then required to reduce the hard copy to microfiche in order to make the entire report available to the Department. Thus, assuming everything proceeds perfectly (which is usually not the case), information received by the Department of Labor is over a year old by the time it is received in usable form. In the event there is any deficiency in the report, the time period is extended by at least 60 days and, if no report at all is filed, that fact is not noted until approximately one year after the due date.

In practice, we believe the situation is even worse. OPWBP field offices complain that they never receive Forms 5500 in timely fashion and, in many cases, it is common investigative procedure to ask a target employee benefit plan to provide the most recent two or three 5500s filed with the government. In the committee's view, the fact that our investigators are now required to ask the public for copies of reports ostensibly filed with the Federal Government reflects badly on the credibility of our enforcement program in general and our procedures for using Forms 5500 in particular.

We believe the main cause of this problem lies in the fact that Forms 5500 are now filed with the Internal Revenue Service for processing and only after such processing are they made available to the Department of Labor. While 5500s are of the highest priority to the Department of Labor in enforcing ERISA, they are of relatively low priority to the Internal Revenue Service, being considered of lesser importance than, for example, Form 1040. As a result of this lower priority, even given the best of intentions on the part of those IRS officials responsible for dealing with Forms 5500, we do not believe the situation can be improved sufficiently in the foreseeable future.

In order to understand the situation better, it might be useful to describe the processing of these reports by the Service. Effective October 1, 1983, the Internal Revenue Service, in response to criticism from the General Accounting Office, instituted a program for detection and correction of deficient and delinquent filings. As the current process is explained to us, when a form is received by any one of ten Internal Revenue Service centers, it is reviewed to determine if approximately 15 predesignated items on the form have been completed. In the event any one of these items is missing, the form is retained for a period of approximately 60 days while a letter is sent to the plan requesting the missing information. The letter currently sent is not specifically designed to deal with deficient Forms 5500 but, rather, is a general letter used by the Internal Revenue Service for all filing deficiencies.[4]

Regardless whether the letter obtains compliance or not, after 60 days the material contained in the Form 5500 is key-punched. If the missing information has been received within the 60 days it is included in the data entered into the computer. If it is received after the 60 days, it is never entered into the system. Despite the fact that data received more than 60 days after the filing of the original form is never key-punched, the Service proceeds to send additional letters beyond that point and, ultimately, if resources are available, might initiate direct contact with plan officials to attempt to obtain the missing information.

The IRS claims to assess fines of $25 a day for each day a deficiency exists. However, the Service has no record whatsoever of what penalties have been assessed under this program or whether collection efforts, if any, have been successful. At one meeting with three mid-level representatives of the Service closely involved with this program, no attendee could state that any fines had ever been collected.

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[4] As an example of the difficulty in getting the service to respond to ERISA matters, we were told that although attempts to get a letter approved which deals specifically with ERISA deficiencies has been underway for some time, no such letter can be approved for use prior to July of 1985.

With respect to Forms 5500 which are not filed, the situation is even worse. At least a year passes beyond the due date of the form before any attempt is made to obtain compliance. A series of four notice letters are then sent and, if resources are available some personal follow-up may occur. Once again, no evidence was presented of any fines being assessed or collected nor were we given any satisfactory assurances that the program is now effectively working.

When asked whether any attempt has ever been made by the Service to compare single employers who had taken tax deductions for contributions to employee benefit plans with whether those employers' plans had filed Forms 5500, we were told one such program had been attempted but had resulted in a total failure. Problems arose in that many employers contributing to multi-employer plans filed Forms 5500 through the plans' administrators rather than in their own names. Also, some employers misstated their Employer Identification Number (EIN) on one form or the other so that the computer would indicate a mismatch when a filing had in fact occurred. Rather than attempt to solve these problems, the Service abandoned the project.

We believe a project along these lines is too important to be abandoned because of the problems encountered by the IRS. Even more importantly, however, we believe that the problems encountered by this project are typical of the failure to make interagency investigative agreements work effectively.

Discussions were also held with Service representatives about the data currently being key-punched from the 5500s. No data whatsoever is entered from Schedule A and only the first three service providers listed by plan administrators on line 12 are key entered. For these and other reasons, the data entered is unusable or unreliable for OPWBP targeting functions. Even the 15 critical items which trigger a deficiency notice consist primarily of status items such as type of plan (welfare, pension, etc.), EIN, name of administrator, total number of participants, etc. For services currently received, the Department of Labor is paying the Internal Revenue Service more than $2 million a year for processing Forms 5500 and is spending another million annually to microfiche them. To key-punch all of the entries on the Forms 5500 and Schedules A and B, would cost the Department approximately $5 to $6 million annually according to representatives of the IRS.

In the opinion of the committee, a solid data base consisting of information reported on Forms 5500 which is made available to field investigators on a timely basis and which is given credibility through an intensive, vigorous and well enforced deficiency and delinquency program is a *sine cua non* of any credible enforcement program undertaken pursuant to title 1 of ERISA. We do not believe we are getting such a program from the Internal Revenue Service. The electronic filing initiative currently underway in OPWBP will go a long way toward resolving this problem, but only if OPWBP can retain control of the data at all times. However, since we do not anticipate 100% filing of Forms 5500 electronically, a better procedure must still be devised for those forms which are filed in hard copy. While we do not recommend going back to the prior system of requiring each employee benefit plan to file two separate forms, one with the IRS and the other with DOL, we do recommend that either the initial filings of Forms 5500 be with the Labor Department for processing and later referral to the IRS or that an independent contractor be considered to handle the forms for both agencies. In either case, all data on the Forms and all attachments must be keypunched. Only in this way can the processing of the forms be done in a manner that reflects the priority the Department attaches to their contents and only in this way can a data base be established which is acceptable for enforcement purposes.

Once DOL has control over the processing of Forms 5500 and takes proper steps to establish a complete and current data base, several very important investigative functions can be served. First, by being able to track specific plans from year to year, the system can be programmed to immediately report any plan which has not made its ERISA filing on time. Second, the system can immediately report on critical elements which have either been omitted or, based on certain cross tabulation formulae, are internally inconsistent. By having this capability, and devoting sufficient resources to its implementation, OPWBP will be in a position to develop a vigorous delinquent report and deficient report enforcement program. A vigorous enforcement program in these areas will have the effect of encouraging prompt and accurate filings from the public which will, in turn, enhance the enforcement potential of the Forms 5500. Additionally, a vigorous reporting enforcement program (with the criminal penalties to back it up) will go a long way toward enhancing program credibility with the general public. Finally, and perhaps most importantly, once we have a current and complete data base, we will be able to engage in more sophisticated computer targeting programs and provide the field with relevant information before it becomes stale.

C. MANAGEMENT ORGANIZATION

In the past, the management structure through which ERISA was enforced was based entirely on the pre-existing LMSA structure to which ERISA enforcement was grafted. The single biggest problem of the prior structure, namely the artificial separation between line and program authority, has now been solved. As a result, even though the Administrator of OPWBP does not have direct authority over litigating ~~attorneys,~~ some criminal investigators within the Department, and those IRS and PBGC employees who deal with title 1 matters, he at least has full control over his own investigators and auditors. This direct control should provide greater responsiveness to policy initiatives, speedier processing of cases and better review of technical matters.

One unfortunate consequence of the previous structure was that field investigative offices reported to LMSA through the Office of Field Operations whereas the National Office of Enforcement reported to the Administrator. As a result of this division of line authority, it was almost impossible to conduct field investigations using National Office personnel. In those situations where such investigations were tried, most notably during the early days of the Central States investigation, the results were disappointing. However, we do not believe that the past failure to successfully conduct investigations directly out of the National Office means that such investigations are impossible for the future. Rather, we believe that certain kinds of investigations can and should be done directly out of the National Office of Enforcement. Three generic types of investigation fall in this area.

The first category consists of those matters which require rapid enforcement action by the National Office. The take-over situations in which the Department has become more and more involved are the best current example of this type of case. Such cases are now, for the most part, handled directly out of Washington. However, no formal structure has been devised and each take-over case has been done on an ad hoc basis.

The second category of cases which should be worked out of Washington, consists of those investigations which are either national in scope or cover a wide area which includes the jurisdiction of many area offices. Ordinarily, these cases will arise as a result of an investigation of a nation wide employee benefit plan or will arise in investigations of service providers who operate throughout the country. The third category of cases would consist of those investigations which are extremely sensitive for policy reasons. All of these cases should be handled by the Office of Enforcement's Division of Investigations (DI). As appropriate, resources of the respective area offices can be incorporated into these investigations to reduce travel expense and to perform specific investigative tasks under the direction of the individual responsible for the investigation in the National Office.

In addition to its role in conducting investigations and reviewing matters for litigation (discussed later in this Report), the Division of Investigations should also be given responsibility for devising and developing special enforcement projects and directing their implementation; collecting investigative techniques developed by the various area offices and sharing them with other offices involved in similar matters; and assuring that all investigative (as opposed to technical) information relevant to specific cases is provided in a timely fashion.

The Division of Field Coordination and Technical Assistance (DFCTA) would be responsible for assuming all of the day to day functions on behalf of OPWBP previously performed by the Office of Field Operations. These functions would include management reviews, administrative support, and merit pay evaluations. In addition, this Division would contain OPWBP's training function and would provide technical assistance to the field in specialized matters such as accounting and difficult fiduciary issues. Also, DFCTA would be the main monitoring mechanism by which the National Office assures itself that its enforcement policy is being properly implemented by the field.

In addition to the areas noted above, the Division of Field Coordination and Technical Assistance would be responsible for preparing and updating all program manuals, Compliance Strategy Documents, technical updates and other material which communicate enforcement policy to the field and insure its proper implementation. In undertaking these functions, the office would communicate regularly with other OPWBP program components and work under the direct guidance of the Assistant Administrator or his deputy.

The Division of Field Coordination and Technical Assistance should be enhanced through the acquisition of a solid core of senior accountants. These individuals should be responsible for devising sophisticated audit programs, both for computer review of Forms 5500 and for use as part of investigative plans for field investigations. These audit programs should be integrated with ongoing policy direction as contained in the annual strategy document and should be used by both field and National Office investigators in the day to day performance of their duties. Additionally, the auditors from this division should be available to assist in specific investigations in which complex accounting problems arise which require their special expertise.

The main function of the Assistant Administrator for Enforcement should be in the areas of developing enforcement policy on behalf of OPWBP and insuring that those policies are implemented by the field and communicated to the public. This will involve representing OPWBP in public forums, such as ALI-ABA conferences, to explain enforcement policy as well as dealing with other-agencies such as DOJ and IRS to insure proper coordination. The Assistant Administrator should also be aware of the Administrator's thinking and policy desires with respect to enforcement and should translate them into specific enforcement policies for implementation by the field. In those arenas in which policy is formulated, the Assistant Administrator should represent the enforcement viewpoint and make sure that in any major issues decided by OPWBP, enforcement ramifications are properly considered. Finally, the Assistant Administrator for Enforcement should be given primary responsibility for implementing the recommendations of this report.

As a result of OPWBP obtaining direct line authority over its investigative personnel and the abolishment of regional offices, a great deal of additional responsibility has been created for the OPWBP Office of Enforcement. To exercise this responsibility effectively, we believe it necessary that the position of Deputy Assistant Administrator be created within that office. While the Assistant Administrator for Enforcement should be primarily responsible for policy matters and coordination with other agencies and the public, the Deputy Assistant Administrator should be given primary responsibility for administering the field program and managing the day to day enforcement operations. This person, in other words, would be responsible for many of the functions previously performed by the head of the Office of Field Operations as well as many of the administrative functions previously performed in the regions. In addition to these administrative duties, the Deputy Assistant Administrator for Enforcement would also be available to perform the duties of the Assistant Administrator during the absence of that person and would provide a sense of continuity in the office.

We believe that the National Office of Enforcement's role in the investigative process will require a considerable enhancement over its present ceiling. Agencies such as the Securities and Exchange Commission now have approximately fifty percent of their enforcement staff located in their national office in Washington. While we do not believe OPWBP will reach that level of centralization in the foreseeable future, we believe a considerably enhanced National Office is essential to provide the overall direction, guidance and expertise necessary for a successful enforcement program.

One major problem which has existed in the past has been the long delays between the completion of an on-site investigation and a determination by the Department of what action to take based on the investigative findings. Any rational management structure must reduce this time gap. One quick way of doing this is to eliminate layers of unnecessary review. Prior to reorganization, an investigator's findings in a major case were reviewed by his or her Track Supervisor, Area Administrator, Assistant Regional Administrator, Regional Administrator, Office of

Enforcement Coordinator, Office of Enforcement Division Chief, Assistant Administrator for Enforcement, and, if litigation were recommended, SOL Staff Attorney, SOL Counsel, SOL Associate Solicitor for PBSD, the OPWBP Administrator and the Solicitor of Labor. At times, one undesirable consequence of this review was a referral of the case back to the investigator for an up-date of the investigative findings. We believe an appropriate enforcement system should provide supervision of the actual investigation combined with one level of independent substantive review. In those situations where policy issues arise or where there is an extraordinary degree of complexity or novelty, National Office policy or technical review may also be required.

There are many different ways of devising a structure which would provide one substantive independent level of review. While it is not the function of this committee to recommend any specific approach, we do believe that in the ordinary civil case, that level of review should be located within each area office itself. In addition, we believe each area office should be staffed in a manner which would allow for the development of expertise as discussed in the training section of this Report and which would permit parallel civil and criminal investigations to be processed through different chains of authority. How these functions can best be accomplished in each office will depend, in large part, on the size of the office and the geographic area of its responsibility.

In the past, OPWBP has not had a consistent view of the duties of its field investigators and, therefore, imposed few requirements in seeking new hires. As a result, in many cases, LMSA investigators were hired with no experience in the work they were asked to undertake. We believe it necessary to upgrade the hiring standards applied to OPWBP investigative personnel. In our view, the best way of doing this is to enter into discussions with OPM to establish specific job qualifications for employment as an ERISA investigator. This approach has already been used in creating a new classification in the National Office; that of employee benefit plan specialist. We believe a new job classification is also required for field investigators so as to allow us to recruit and obtain individuals with ability to conduct financial, criminal or complex civil ERISA investigations.

In routine civil investigations which disclose clear civil violations of ERISA, we also believe an investigator should be permitted to discuss his or her tentative findings with plan officials provided he or she emphasize that the views being expressed are subject to review and provided prior supervisory approval is obtained. In appropriate cases, an investigator should also be authorized to seek immediate voluntary compliance, again subject to cautioning plan officials that his or her views might be rejected by the agency. In all cases, any findings by an investigator of title 1 ERISA violations should subsequently be reduced to writing and, after review at an appropriate level within OPWBP, communicated to plan officials. If voluntary compliance has already taken place as a result of the investigator's conversations with plan officials, that fact should be noted in the communication. In situations where the violation is non-abusive or technical, plan officials should generally be allowed a meeting with appropriate supervisory personnel prior to the initiation of enforcement action. However, in those situations where there is a flagrant abuse or where there is a risk of continuing diversion of plan assets, no communication should be required prior to the initiation of appropriate enforcement proceedings.

At the present time, we do not believe any civil litigation should be initiated by OPWBP without review by the Office of Enforcement. In cases where the litigation is to be conducted out of Washington, the report of investigation and entire exhibit file should be sent to OE for transmittal to PBSD. With respect to decentralized litigation, a copy of the ROI and transmittal memoranda, without exhibits, should be sent to OE at the same time the case is referred to RSOL. With the exception of those cases requiring emergency attention, OE should be required to review all reports of investigation and memoranda which recommend regional litigation within five working days of receipt and, if problems exist, communicate immediately with the proper individuals. Such OE review should be limited to questions of policy and technical interpretation of ERISA. OE's review of decentralized litigation should not involve the sufficiency of evidence or other purely investigative matters unless assistance or guidance is requested. These matters, as a rule, should be resolved between the area office and RSOL with the matter only coming to Washington if problems arise. OE, however, should continue to play a role in these areas with respect to litigation which is not decentralized.

D. FOLLOW-UP

One recurrent problem we have found in almost every single enforcement area is the lack of follow-up on any initiatives which have been undertaken. This is true in the areas of training, targeting, voluntary compliance, referrals to other agencies and other investigative matters. To a large extent, these problems have arisen as a result of lack of tight management as well as lack of clear policy direction from the Office of Enforcement. In addition to better management and use of ADP, other specific steps can be taken. One step would be to include a provision in all voluntary compliance agreements arising from continuing violations (as opposed to the correction of a single transaction) whereby the subject of the investigation agrees to allow the Labor Department reentry one year from the date of the agreement to monitor compliance. If compliance has been obtained through a judicial consent decree, violation of this provision could result in a contempt citation. Even if the agreement has been made without a formal court order, such an agreement would provide a better basis to obtain access in the event an OPWBP investigator is challenged by the subject. Such an agreement, except in rare cases, should always be followed up one year later by an on-site visit.

Equivalent follow-up procedures should be instituted for all referrals to the Department of Justice, the Internal Revenue Service, and other agencies. With respect to potential IRS section 6103 disclosure problems, a system can easily be devised whereby all referrals contain a disclosure request for tracking purposes. An alternative approach would be a more generalized disclosure request for follow-up information with respect to all matters referred to the IRS by DOL pursuant to the existing referral agreement. As noted elsewhere in this report, six out of seven closed cases referred to the IRS have not resulted in the imposition of an excise tax. Any useful follow-up procedure would require the Department being notified of the reason why no tax was imposed.

Conversely, when referrals are made to us or from one OPWBP office to another, follow-up should be given to the referring office as a matter of course. No case should be closed for tracking purposes until final disposition by the agency ultimately having responsibility for the matter.

E. FIELD EVALUATION

In the ten years of its existence, no fully successful method has been devised to properly evaluate field investigative performance. During the greater portion of this time, such evaluations were performed primarily by the Office of Field Operations and by data collected through FARS. Both of these systems resulted in a quantitative as opposed to qualitative analysis and tended to reward those field managers who produced numbers rather than good cases. The significant case procedure, was criticized as being too subjective and for this reason, was never effectively used for merit pay purposes. Another evaluation approach was to measure field performance in terms of assets preserved or restored, but this too quickly developed into a numbers game which hid the true purpose of an enforcement program.

Unfortunately, the committee has not devised a fool-proof mechanism by which to measure field performance. However, certain areas of agreement have been reached. First, a strictly numbers approach does not evaluate success with respect to enforcement; it simply judges the ability to generate data. Second, field evaluations should be based more on quality than quantity. Third, the way in which the field should be judged should be the degree to which its efforts are directed toward the implementation of national OPWBP policy and the success it attains in that pursuit. In other words, a good office is one which responds quickly to direction, conducts its work in a timely, efficient and thorough manner and produces a result which will stand up to scrutiny and review. A "hit ratio", which measures only the detection and prosecution of violations is important, but relates as much to targeting as it does to investigative ability. For these reasons, the committee recognizes that there will always be a certain degree of subjectivity in judging investigative accomplishments.

Discretion should be given to field managers to abandon less fruitful avenues of investigation and concentrate resources in those areas most likely to produce positive results. To reenforce this, field managers should be given authority to close cases at an early stage when, in their judgment, further investigation would not be fruitful. Field managers should also be given the authority to simplify and shorten the process through which "no violation" cases are handled so that in those situations where an investigation results in negative findings the matter can be quickly put to rest and the investigator assigned to other duties. How well field managers exercise judgment in these areas is one important factor on which they should be judged.

With the elimination of regions and the concentration of line authority and program authority under the same direction, it is anticipated that the Office of Enforcement's Division of Field Coordination and Technical Assistance, in conjunction with OPWBP field office managers, will, as one of its first major undertakings, develop new methods of measuring and evaluating field performance.

F. TRAINING

As can best be determined, during the entire ten year history of OPWBP, only four National Office training courses have been prepared for general use in the field. These courses have covered the subjects of fiduciary, basic skills, insurance and criminal investigations. Even these courses, while national in terms of being provided to all investigators, were prepared and given primarily by field personnel. This indicates to the committee that the National Office has done much less than it should in the area of training. The necessity for the national office to assume greater responsibility for and involvement in training is increased by the imminent elimination of the six regional offices which in the past have provided the main source of non-on-the-job training. For these reasons, we believe it imperative that a training staff be established within the Office of Enforcement in Washington.

In our view, a national training staff should develop an in-house training capability which would provide certain core training to all investigators and auditors. This would include courses in basic skills such as investigations, auditing and report writing, a basic fiduciary course and a basic criminal investigation course. The national training office should also be responsible for the development of an advanced fiduciary course which should be given on a selective basis to senior OPWBP investigative personnel. In addition, the training office should be responsible for developing training courses with respect to special enforcement projects, such as soft-dollar.

For other specialized areas in which OPWBP must maintain a presence, such as real estate, banking, finance, investments, computer auditing, advanced criminal investigations, stock valuation, etc., OPWBP should rely on outside sources for training. One way of accomplishing this is to include OPWBP personnel in training sessions provided to government investigators and examiners in agencies which specialize in those areas. Additionally, academic training through night school or other private sources should be utilized. The national training office should act as a coordination point for this outside training and should have some responsibility in the allocation of funds to be sure that this training is properly implemented.

With respect to the specialized areas listed above, the National Office, through its annual compliance strategy document, should indicate to the field those areas in which specialized expertise will be desirable. Each area office should decide how it will achieve the degree of specialization necessary to meet the program's goals, and select the individuals, subject to National Office review, to receive specialized training. With the exception of the core courses, and certain on-the-job training discussed below, we do not believe the same training should be given to each individual. We believe that specialized skills should be developed in individual investigators over time so as to provide each area office with both skilled specialized investigators and resource people from whom other investigators in the field can obtain technical guidance and direction.

Recently, an attempt was made to adopt a systematic approach to on-the-job training by developing Individual Development Cards (IDC) in specific subject areas. These IDCs appear to be a useful and fruitful device and their completion should be encouraged so that the field will at least have some guidance to insure that on-the-job training is consistent from office to office throughout the program.

CLIMATE OF ENFORCEMENT

Almost one entire meeting of the Enforcement Working Group was spent on a discussion of whether a climate of enforcement exists within the Department of Labor and, if not, what can be done to obtain such an environment. The current enforcement climate was characterized by some participants as lacking zeal and passion within the Department for the enforcement of Federal laws. This lack of commitment was discussed in many of its applications, including what was felt by some participants to have been a delegation of criminal investigative responsibility by the Department to the Department of Justice and an attitude within the Department that most major structural, personnel and other decisions are made without sufficient regard to their impact on enforcement. In fact, law enforcement is such a small component of the Department of Labor's overall mission that most major Departmental decisions affecting law enforcement are made by individuals far removed from responsibility for the enforcement process. Other impediments to vigorous enforcement were seen in the Department's institutional separation of authority among at least three separate agencies as well as the separation of authority between the Department itself and other Federal agencies.

It was also noted that the Department's efforts to enforce ERISA have been the subject of an extraordinarily high degree of scrutiny and criticism from Congress, GAO and others. Perhaps as a result of this scrutiny, a lack of continuity and stability of enforcement policy was noted in that no policy, no matter how well articulated, has continued beyond the tenure of the individual responsible for its implementation. Some committee members believed that the Department has, at times, appeared paralyzed by outside criticism to the extent that it has not tried to define its own enforcement priorities in light of its past successes. Others felt that a climate has been created which has inhibited the aggressiveness of certain personnel for fear that a change in policy or direction of the program could result in "punishment" for having shown excessive zeal in support of an outmoded policy.

There was general agreement among the committee members that ERISA enforcement requires greater independence from outside influences and greater continuity of policy so that investigators and mid-level managers can proceed to enforce the law in a vigorous fashion without fear of being contradicted or overruled by future changes at the top. Bluntly, political appointees are present to take the heat; the only heat that should be felt by career personnel is that generated by a failure to vigorously and effectively pursue a legitimate policy in effect at any given time.

In addition to greater stability, the Department of Labor does not seem to encourage prudent risk taking on the part of enforcement personnel. Performance by which individuals are measured and promoted too often ignore accomplishments in the enforcement area in favor of other methods of measurement. If OPWBP is to be a credible enforcement agency, its enforcement personnel should be primarily judged on how successfully they enforce ERISA. Everything else should be considered secondary. This approach should also prevail in deciding matters such as field structure, resource allocation and policy formulation. Whether such an enforcement mentality can prevail in the Department of Labor was viewed with skepticism by some members of the committee.

Although it was recognized that giving the Administrator of OPWBP direct line authority over field personnel was an extremely important positive step in curing the fragmentation of ERISA enforcement, it was also recognized that more has to be done. Ultimately, it may well be that only a separate agency which contains all the components necessary to establish and enforce a Federal pension policy may be necessary to effectively fulfill the promise of ERISA.

Under present circumstances, four specific steps should be taken by the National Office to enhance ERISA enforcement in the field. First, the OPWBP National Office must create and foster a climate of enforcement which would allow the field to actively undertake ERISA investigations without fear of future criticism based on future changes in policy. Second, the National Office of OPWBP should give strong and specific directions to the field of what policies should be pursued at any given time. Third, the National Office should hold the field strictly accountable for success or failure based solely on the policies previously enunciated and resources available to implement them. Finally, the National Office should respond quickly to the field not only in processing reports of investigation but also in responding to issues and problems as they arise. In short, the National Office should be responsible for telling the field what to do, giving it the resources to do the job and judging the field solely on its success or failure in doing so. In the event future changes in policy are made, no investigator should be held responsible or criticized for vigorously implementing a previously announced policy during the time that policy was in effect.

CONCLUSION

After analyzing all aspects of ERISA enforcement, the ERISA Enforcement Working Group has concluded that much room for improvement exists in the areas of targeting, training, relations with other agencies, internal organization and policy direction. However, the main conclusion reached is that even if the program were organized in the best possible way and performing with 100 percent efficiency, the resources currently available are totally inadequate. Major personnel and material enhancements are necessary to allow even the most minimum level of credibility to be established within the employee benefit plan community. Only when such credibility is established can ERISA enforcement be said to be operating at a fully successful level.

ATTACHMENT 1

IMPROVING THE USEFULLNESS OF INDEPENDENT PUBLIC ACCOUNTANT'S WORK

PREPARED FOR THE
PWBP ENFORCEMENT WORKING GROUP

PWBP Enforcement Task Gro
June 14, 1984

DIGEST

This report was prepared at the request of the Pension and Welfare Benefit Programs, Enforcement Working Group. It addresses weaknesses in PWBP's use of independent public accountants (IPAs) to augment its ERISA enforcement responsibilities.

Although ERISA audit requirements should result in IPAs examining nearly 88 percent ($503 billion) of all employee benefit plans funds, the effort is of little enforcement value. The report discusses the need to assure the audits are completed and that information disclosed by IPAs is useful to PWBP's enforcement staff.

Also presented in this report is a description of the Securities and Exchange Commission's relationship with self-regulatory associations; an arrangement that may have applications to PWBP's enforcement of the ERISA.

CHAPTER I

Making Better Use of Other Professional's Work

Requirements of the ERISA, intended to afford protection to participants and assistance to PWBP in enforcing its provisions, are contained in Section 103. The Act requires plan administrators prepare an annual report and to engage an "independent qualified public accountant" (IPA) to examine the financial statements of the plan. By regulation, any plan of 100 participants or more must obtain an annual audit by an IPA. The Act makes mandatory an opinon on the financial statements and an actuarial opinion and statement. Also included with the Act are requirements that supplemental information disclose assets held for investment, material commitments, contingent liabilities, priorities upon termination of the plan, transactions with parties-in-interest, loans or fixed income obligations in default, leases in default and transactions involving more than three percent of the current value of plan assets. The accountant's report is required to be attached to the Form 5500 filed by the plan administrator.

The number of plans subject to this audit requirement, based upon analysis of 1981 Employee Plan Master File data, is approximately 88,000, or less than 12 percent of the total estimated number of plans in existence. However, plans subject to audit represent about $500 billion or over 88 percent of the total estimated plan assets.

The litany of information required by ERISA reporting and disclosure standards and the coverage obtained by current audit requirements, should assist PWBP in identifying fiduciary violations, prohibited transactions and imprudent management of plan funds; all violations of the ERISA. However, the work of IPA's is not as useful as it should be. A number of weaknesses have been identified in reviewing PWBP data and decisions with enforcement staff. Specifically PWBP does not have an effective means of assuring IPAs that:

-- examinations have been completed and a report submitted with the Form 5500's, Annual Return/Report

-- reports meet disclosure requirements of the ERISA;

-- reports provide information to PWBP in a manner and form useful for enforcement purposes.

Background

Since 1979, the Internal Revenue Service (IRS) has been the source of plan financial information for PWBP. Through a DOL/Treasury agreement PWBP reimburses the IRS approximately $2 million annually to process the Form 5500's, extract selected data from the Form 5500's, provide PWBP magnetic tapes containing the information, assure delinquent files are pursued and follow-up on deficiencies and omissions found on the Forms.

After IRS processing, the Forms are provided to a DOL contractor who microfiches the information (at a cost of over $1 million annually), for use by PWBP in responding to "hard copy" public disclosure requests and for review by PWBP field enforcement offices.

The reporting arrangement has historically been a source of friction between PWBP and the IRS. PWBP has charged that the information received from the IRS was often incomplete and received so late that, in some instances, it jeopardized the statute of limitations. In addition, PWBP insisted that the IRS gave low priority to detection and follow-up of delinquent and deficient filers.

Some PWBP field offices have such low regard for either microfiche copies or National Office targeting programs developed from IRS supplied tapes that they have made arrangements to visit IRS Service Centers to review and secure copies of the Forms.

There is no evidence to suggest the responsibility for routine follow-up on deficient and delinquent reports should be returned to PWBP or that dual filing with PWBP and the IRS would serve

PWBP's needs. The IRS is better equiped, through development of automated systems, staff resources and its collection powers to perform these functions. Further, the IRS has recently begun to assess more stringent civil penalties for Form 5500s which contain omissions, have not met the filing deadlines or do not contain required attachments.

However, as discussed in the following sections of this paper, there is a need for PWBP to reclaim its authority to impose and enforce reporting and disclosure requirements more closely related to its enforcement objectives.

Assuring Examinations are Completed

In order for the results of IPA examinations to be of benefit, they must be available. As discussed in OIG's March 22, 1984 report Recommendations for LMSA Reorganization, PWBP has in the past had no procedures to assure independent audits required by the ERISA were being accomplished. Enforcement of the audit requirements by PWBP has generally been limited to attempts by PWBP field staff to obtain voluntary compliance of delinquent filers, on those plans selected for review.

PWBP's National Office indicated it has recently developed procedures to identify and follow-up on plans which are subject to the requirement and have not obtained an audit. However, PWBP indicates it intends to seek voluntary compliance.

It is a reasonable assumption that those plans which do not voluntarily comply with the audit requirement are most in need of examination and have, in the past, received the least scrutiny. Therefore, PWBP when necessary should seek assistance from the Office of the Solicitor (SOL) and the IRS as appropriate, to force compliance.

Making PWBP a Party to the Auditor's Report

A complaint frequently expressed by PWBP staff regarding the work of IPAs is the reluctance of the auditor to disclose information detrimental to the interests of the client; even in instances in which fraud may be involved. Other IPA audits of pensich plans are done in conjunction with the annual audit of an employer who is the plan sponsor. As such, the employer in relation to the pension plan, is viewed as the client.

The ERISA clearly indicates audit requirements are for the protection of the participants. Section 103(a)(3)(A) requires: "...the administrator of an employee benefit plan shall engage, on behalf of all plan participants, an independent qualified public accountant, who shall conduct such examination..."

However, The American Institute of Certified Public Accountants' Codification of Statements on Auditing Standards (AU 328) provides the following guidance to its members:

> ".19 Deciding whether there is a need to notify parties other than personnel within the client's organization of an illegal act is the responsibility of management. Generally, the auditor is under no obligation to notify those parties. However, if the auditor considers the illegal act to be sufficiently serious to warrant withdrawing from the engagement, he should consult with his legal counsel as to what other action, if any, he should take."

In instances of fraud and non-compliance with ERISA mandates, employee benefit plans are more at risk than Federally assisted programs. In regard to audits of Federal grantees the SAS AU 9317 provides:

> ".12 Governmental requirements, however, call for the auditor not only to promptly report instances of irregularities of the audited entity's management officials above the level of involvement, but also to report the matter to the funding agency or other specified agency."

Further:

> ".13 ...it would not be appropriate for the auditor to withdraw from the engagement without first reporting the irregularity or illegal act to management and appropriate federal agencies.
>
> .14 In an audit of a federally assisted program, the auditor may find instances of non-compliance with the terms of a grant award which by their nature are not irregularities or illegal acts. In those situations the auditor should disclose significant instances of non-compliance in his report, but ordinarily he would not have to otherwise notify the federal agency."

There is a need to establish a reporting obligation between the IPA and PWBP to assure problems are identified and communicated to PWBP. In a real sense, the federal government has as great an interest in financial operations of pension plans, through its contingent liability involving benefit guarantees of the Pension Benefit Guaranty Corporation as it does for federally assisted programs.

Determining Enforcement Disclosure Needs

Since the ERISA was passed, PWBP has experienced difficulty in coping with the volume of data it receives and in developing meaningful ways to analyze the information for enforcement targeting purposes.

PWBP's approach to enforcement targeting as it relates to the Form 5500's received, has been to conduct numerous experiments involving computer based and manual analysis of the data. There is no standard criteria among field offices, little documentation of methods to be used or agreement as to the best indicators of a violation. A substantial amount of time has been devoted to analysis of the Form 5500s and other targeting methods (as much as 20 percent of available enforcement time in some field offices).

The performance of PWBP field offices in detecting violations has been erratic. Nationally, Fiscal Year 1983 statistics indicates that 64 percent of PWBP field office cases contained no violations. Unsuccessful cases among offices ranged from a high of 90 percent to a low of 35 percent.

The mixed results of PWBP's targeting attempts demonstrates an overall weakness in the Agency's ability to make use of the information it receives. Further, many of the cases opened by PWBP which contained significant violations, reflected in the statistics above, were the result of tips, referrals from outside the Department and other sources of intelligence.

We believe problems experienced by PWBP in using the Form 5500 information results in part, from the Agency's failure to identify and require disclosure of information which meets its enforcement needs.

The reaction of PWBP (and other users of the Form 5500s) in attempting to make it more useful, has been piecemeal additions, from year-to-year of additional disclosure requirements without effective analysis of what information contained on the Forms would have led to discovery of a violation.

As part of our involvement in this review, we prepared a listing of items whose disclosure we believed is critical to the compliance requirements of PWBP. The listing (see Attachment A) should not be considered all inclusive, as it was developed within the context of the experiences and exposure of the limited number of individuals involved in this Working Group. It should, however, serve as a guide for a comprehensive review of disclosure requirements which will meet PWBP's enforcement objectives. A discussion of how the information should be transmitted to PWBP is addressed in the following sections of this report.

Tailoring Disclosure Requirements to Enforcement Needs

One concern raised by PWBP staff, during the course of this review, involved the unlikelyprospect that IPA's would report to PWBP violations of ERISA compliance requirements.

It is unlikely and probably inadvisable, particularly due to the complex nature of some ERISA provisions which often require legal interpretation, that the accounting profession make judgments as to whether a violation of the ERISA has occurred (although this is done as a matter of course in federal grant audits performed by IPA's).

However, the IPA can be required to disclose a "reportable event" in a format which will allow a determination by PWBP of whether the incident warrants investigation.

As part of our review, we conducted a limited examination of reporting requirements imposed on the securities industry by the Securities and Exchange Commission (SEC). We found most SEC required reports are formatted in a manner so they bear a direct relationship to compliance requirements. Further, the burden of financial analysis necessary to determine if a securities dealer has violated an SEC requirement is placed upon the dealer (and s public accountant for both interim and annual filings) and made part of the disclosure requirement. Finally, the SEC imposes a de facto violation reporting requirement on the accountant.

For example, the SEC has established net capital requirements for brokers and dealers.

The broker and dealer may not allow his aggregate indebtedness to exceed 1500 percent of his net capital. The IPA is required to test for this compliance requirement. If the broker's and dealer's indebtedness has exceeded the limitation, the accountant required to obtain proof that the broker and dealer has notified the SEC by telegram. If the accountant does not receive proof of notice within 24 hours, the accountant is responsible for informing the Commission, by telegram, within 24 hours (17CFR 240.17a-5(h((2)).

The SEC's regulation requires the accountant to ensure specific disclosure is made to the Commission which is, in fact, enforcement of a compliance requirement.

Finding a Vehicle for Reporting Problems to PWBP

suring plans are examined, reports are provided PWBP and information they contain satisfy PWBP enforcement needs, will not alone, improve enforcement results. A means must be established to screen the information and convey it to enforcement staff without inordinate review.

Some of the problems experienced by PWBP staff in using the Form 5500 as an enforcement tool are the result of inherent flaws which we do not believe can be easily corrected and are so debilitating other means of PWBP disclosure should be developed.

The Form 5500's and the required attachments are intended to serve the unique financial information needs of the IRS, PWBP, PBGC and the Social Security Administration. In addition, they must contain data necessary for statistical studies, extracts and tabulations. Designing a form which satisfies the diverse requirements of four separate agencies which also include public disclosure and enforcement needs, in an arena of constantly changing regulations, was described by one PWBP official as akin to "nailing Jello to a tree". The value of the 5500's for enforcement purposes, is further reduced, as previously discussed, by their late receipt and the volume of the filings.

Using the IPA's report as an enforcement disclosure vehicle presents many of the same problems that are faced in using the Form 5500. If staffing levels remain relatively constant, PWBP's 460 employees annually, would be required to review an estimated 88,000 reports.

The problems associated with the large volume of reports was evidenced in two plans reviewed in Atlanta. In both instances, violations of ERISA 406(a)1 provisions, involving loans of over $3 million to parties-in-interest, were identified.

The accountant's reports properly disclosed the information in attached schedules of "Party-in-Interest Transactions". However, neither case was initially opened as a result of PWBP staff review of the audit reports.

Further, the IPA's reports are now submitted as an attachment to the Form 5500, hence they would not be available for review until the Form 5500 was provided PWBP through the IRS.

The solution, is to require plan administrators and IPA's upon discovery, to immediately disclose to PWBP any "reportable event" (as discussed in the previous section under "Tailoring Disclosure Requirements to Enforcement Needs") which PWBP by regulation had certified as such. Any compliance concerns should also be made part of the IPA's report.

To avoid being burdened with unproductive filings, occurrences identified as "reportable events" should only represent those transactions with the greatest potential of representing a violation.

Getting the Attention of the Accounting Community

Altering current ERISA reporting and disclosure requirements and the responsibilities of public accountants will require changes to either the statute and/or regulations. The cooperation and assistance of the AICPA should be solicited in implementing changes and assuring they are disseminated to its members. To be effective, any changes in disclosure requirements of the ERISA, related to IPAs' responsibilities, must be monitored and as necessary, enforced.

In the past, PWBP has not sought action against accountants or other professionals who, as a result of their actions in a professional capacity, have contributed to violations of the ERISA.

In contrast, the SEC under its Rules of Practice (17 CFR 201.2(e)) has the authority to prevent any culpable individual from practicing before the Commission:

> " Suspension and Disbarment. (1) The Commission may deny, temporarily or permanently, the privilege of appearing or practicing before it in any way to any person who is found by the Commission after notice of and opportunity for hearing in the matter (i) not to possess the requisite qualifications to represent others or (ii) to be lacking in character or integrity or to have engaged in unethical or improper professional conduct, or (iii) to have willfully violated, or willfully aided and abetted the violation of any provision of the Federal securities laws (15 U.S.C. 77a to 80b-20), or the rules and regulations thereunder."

There is an "automatic" denial provision for any "expert" whose license to practice has been revoked or who has been convicted of a felony, regardless of whether an appeal is pending.

The Commissions sanctions administered through a hearings process also extend to professional care and in some instances, have resulted in permanent suspension of partners and censure of the firm.

PWBA enforcement staff should evaluate the IPA's compliance with

ERISA provisions and where inadequate disclosure or other problems noted refer them to the Office of Solicitor for action.

1/ SEC Docket Vol. 14, No. 19, June 13, 1978

RECOMMENDATIONS

We recommend PWBP with the assistance of the Office of the Solicitor as appropriate:

1. Aggressively pursue employee benefit plans which are subject to the audit requirements of the ERISA and have failed to comply. Plans which do not voluntarily comply should be referred to the Office of the Solicitor for action.

2. Develop regulations which establish a reporting obligation between the IPAs and PWBP for both illegal acts and ERISA compliance requirements.

3. Identify the critical compliance requirements of the ERISA and information which is the most indicative of ERISA violations.

4. Develop IPA disclosure requirements and reporting formats which to the maximum extent possible, allow PWBP to determine if a violation has occurred.

5. Establish regulations which require IPA to make immediate disclosure of "reportable events" to PWBP.

6. Incorporate in PWBP field audit procedures a requirement that the IPA's report be reviewed for adequacy. Deficiencies should be referred to the Solicitor's Office for action.

Chapter II

Making Use of Self-Regulatory Organizations

There are many parallels between PWBP and the SEC in the problems they face attempting to enforce the statutes for which each is responsible. However, the SEC has unique associations with self-regulatory organizations and independent parties which assist the SEC enforcement efforts. The help obtained from these associations and control the SEC exercises over them, may have applications to PWBP's enforcement of the ERISA.

Limited Resources

The Securities and Exchange Commission (SEC), through the Securities Exchange Act of 1934, and subsequent ammendments and regulations, has responsibility for a variety of regulations governing the activities of security brokers and dealers, investment companies and investment advisors.

Like PWBP, the SEC faces difficulty with the resources it has in providing coverage of the universe of regulated entities.

In the Atlanta SEC Regional Office, which we visited, there were approximately 35 professional staff for about 1700 registered advisors, brokers and dealers and investment companies; a ratio of one professional to 49 regulated entities.

Although the workload may be substantial, it does not approach that of PWBP. Nationally, PWBP's staff of about 480 are responsible for an estimated 700,000 employee benefit plans or over 1400 plans per individual.

Increasing the size of PWBP's enforcement staff, even by several fold, would not appreciably increase the enforcement coverage or assure compliance with the ERISA.

Both PWBP and the SEC obtain assistance from private sector organizations in controlling the activities of regulated entities. However, there is a marked difference between the involvement and assistance obtained by the SEC and that available to PWBP.

Help From the Outside

SEC regulations required brokers and dealers involved in public trading, to be a member of either a registered national security exchange or a registered association of brokers and dealers.

Both the exchanges and the brokers and dealers associations are empowered by statute to enforce many of the provisions of the federal securities laws. The National Association of Security Dealers, Inc. (NASD), which was the focus of our review, claims the membership of almost 90 percent of all broker-dealers involved in the public securities business. The NASD is a self-regulatory organization of the securities industry whose activity is funded by the entities it regulates.

The NASD's Surveillance Department consists of several sections ~~which carry-on~~ such activities as processing financial information received from members, conducting programs to detect fraudulent and manipulative activities and administering regulatory programs.

All brokers and dealers involved in general securities business are subject to audit by either an association of brokers and dealers or an exchange. NASD performs a minimum of one on-site examination per year of each broker and dealer. Audits are conducted on a surprise basis.

The examination includes in part, a review of business practices, the accuracy of the broker's and dealer's records, compliance with anti-fraud and registration provisions of the Securities Exchange Act of 1934 and the Securities Act of 1933. In addition, the firm is reviewed to determine if it is financially sound enough to continue business.

The NASD has essentially the same powers as the SEC in enforcing the Act's provisions. It can through a hearings process fine a firm for violations and if warranted expel a firm from the Association. Expulsion can result in a firm being excluded from the securities business.

Review by the SEC

The operations of the NASD and all associations and exchanges are subject to periodic review by the SEC. Any information pertaining to examinations, filings, complaints against members or any other data collected or developed by the associations is available to the SEC. The existance of the associations and exchanges self-regulatory programs does not restrict the SEC from taking any enforcement action it feels is appropriate.

RECOMMENDATIONS

The association between the SEC and self-regulatory organizations is presented to the reorganization committee as a model of what appears to be an effective self-policing mechanism. It represents a means of allowing PWBP to augment its enforcement resources and coverage of the universe of employees benefit plans.

To create such self-regulatory organizations would require sincere interest by the private sector, perhaps from employee benefit plan administrators or plan sponsors. It would also require substantial legislative and/or regulatory changes.

Listing of Reportable Items Attachment A

Listed below are items considered by the Working Group as significant enough to require immediate disclosure to PWBP by the IPA. The Group proposes requiring detailed supporting information for any question in which a positive response is indicated. The format of the disclosure has not been determined.

1. Did the plan hold over 30 percent of its total assets in any one security, debt, mortgage, real estate or other property? 1/

2. Were any discrepancies noted between management practices and the provisions of the plan document?

3. Does the plan hold real estate which has not been appraised within the past 12 months?

4. Does the plan hold employer securities which have not been valued within the past 12 months?

1/ There is no established standard above which lack of diversification can be said to exist. Thirty percent was chosen by the Task Group as a figure above which review is considered prudent.

Attachment A (Cont)

5. Are any plan assets not reported at current value?

6. Does the plan lease real property to the plan sponsor which involved only one parcel?

7. Does the plan hold qualifying employer securities and/or real property in excess of 10 percent of the fair market value of the plan assets (individual retirement accounts and annuities are excluded from this requirement).

8. If the plan leased or rented real or personal property to the plan sponsor were payments determined on a basis other than currentmarket conditions?

9. Did any employees of the plan receive full-time compensation from a sponsoring employer or employer organization?

10. Did the plan engage in any transactions with parties-in-interest other than those specifically allowed in Section 408 of the ERISA?

11. Were any loans by the plan, fixed income obligations or leases involving the plan in default at the close of the year or classified as uncollectable?

12. (Welfare Plans) Does the plan hold individual insurance policies on participants?

13. (Welfare Plans) Does the plan hold whole life insurance policies on participants?

14. Were any plan-loses attributable to fraud or dishonesty during the year?

15. Was an adverse opinion issued on the plan financial statements?

ATTACHMENT 2

DATA PROCESSING OPTIONS FOR ERISA ENFORCEMENT

Technical Memorandum

W27-M-167

Susan G. King
Norm Bourque
July 24, 1984

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1. PURPOSE AND SCOPE

This document covers a set of data processing options which may be used to facilitate the Department of Labor's Employee Retirement Income Security Act (ERISA) enforcement effort. These options have been selected to cover a range of functionality, from a minimum automated system for the national Office of Enforcement (OE) to a full set of functions for the national and field offices.

This document focuses on the establishment and use of an in-house data base for ERISA enforcement. The more sophisticated options selected include the electronic filing of 5500 data. This concept is being explored in a separate effort which is being coordinated with the one documented here.

An operating concept (i.e., a high level description of system operations), a conceptual hardware and software architecture, and an estimate of the life cycle cost based on components of the needed scale and type are provided for each system option. An estimated implementation schedule and staffing level for each option is also included.

The system options analyzed here include data entry, from key entry to electronic filing. (Some key entry will be required even with the use of electronic filing; without electronic filing, much more key entry would be needed.) The options do not include any of the manual operations associated with data receipt and dissemination.

These materials are intended to give the Department of Labor (DOL) a range of functional options and corresponding cost estimates as a basis for making decisions on system automation. They do not constitute recommendations of specific hardware or software components.

2. TECHNICAL APPROACH

The process of arriving at the estimates contained in this document began with a series of meetings with DOL staff in which a set of functions for the minimum system (Option 1) and maximum system (Option 4) were developed. A study was then made of the types and volumes of data to be handled by each of these system options. Operating concepts, based on these functions and data, were written for these two options and their life cycle costs and implementation schedules and staffing levels were estimated. Options 2 and 3 were then selected to provide feasible intermediate functional support and cost.

3. ASSUMPTIONS

The following set of assumptions has been used as a basis for the estimates of system size and implementation timing contained in this document.

3.1 Sizing Assumptions

The conversion of historical data will take place primarily off-site. In the case of Option 4, where excess capacity will be available outside of peak operating months, some conversion may take place on-site.

Data volumes received and generated will not increase significantly over current levels.

Data input will be accomplished on an 11-hour day, five-day week basis, except for a one-month peak input period for Options 3 and 4 when a 16-hour day, five-day week operation will be needed.

Data retrieval will be available on a 24-hour day and five-day week basis; the computer system will operate unattended for eight of the 24 hours. (If the system functions were accomplished by a service bureau, fully staffed operation would be available for 24 hours a day and seven days a week at a possibly lower cost. However, DOL would have less control over such a computer system and, probably, a lower priority for service and response time.)

There will be 25 field offices, with a total of approximately 750 professional staff, during the eight-year system life.

The OE professional staff level will be approximately 30 during the eight-year system life.

For electronic filing, fewer than one percent of submissions will arrive on magnetic tape; no more than 1.5% will arrive on phone lines; the remaining submissions will arrive on floppy disks.

Detailed on-line reference to 5500 data will be primarily needed for active cases (about 2000/year).

On-line read-only access to the detailed data used for the investigation of open cases will be needed at all offices.

All stored computer-readable data will be accessible in batch mode for computer targeting, legislative analysis, statistical reporting and workload measurement.

Input of 5500 data will be accomplished only at OE. Other data input relevant to an open case will be accomplished only at OE or, for Options 3 and 4, at the office where a case is being handled.

The responsibility for receipt, management, and dissemination of the 5500 data will not reside in the enforcement organization. (The addition of these functions would increase the estimated operating costs.)

3.2 Scheduling Assumptions

Staff resources, both contractor and DOL, will be available at the appropriate times within the implementation schedule.

Facilities which are adequately sized and prepared to support the hardware being procured will be available when needed.

Applications software may be developed off-site. (Otherwise, hardware and systems software would need to be procured sooner.)

The preliminary studies and the system and programming designs will be accomplished by the same organization. (This assumption implies the possibility of partially overlapping some of these related efforts; if they were done by different organizations, none could be started until the previous task(s) on which it depends were finished.)

4. FUNCTIONAL SYSTEM DESCRIPTIONS

Tables 4-1, 4-2, and 4-3 describe a set of four system options in terms of the level of functions performed and data handled and retained. The operating concepts which follow embody the options covered by these tables in a descriptive form.

4.1 Option 1 (Minimum) System Operating Concept

Each year of the planned eight-year system life, a total of 850,000 forms in the 5500 series will be submitted. All data on the forms (approximately 4 billion bytes per year) will be put into computer-readable form with off-line key-to-tape or key-to-disk technology. The key-to-tape or -disk data transfer will be evenly spaced over the year.

The contents of the magnetic tapes or disks will be transferred to on-line storage in a batch operation. All data entered will be edited for data type, field length, and internal consistency.

An additional 7 million bytes of data will be generated each year at the national office in the form of indexing and case tracking information. An additional million bytes of text data (intelligence file items originated at the national office) will be generated on a national office integrated word processing system and retained in the computer system. Three word processing workstations with associated letter-quality printers will be used at the national office to generate correspondence.

TABLE 4-1, PART 1 OF 4

SYSTEM FUNCTONS

Function	Level			
	Option 1	Option 2	Option 3	Option 4
1. Data entry				
a. Of data generated by filers (5500s and attachments)	Data received on paper; numeric, check-box & identification data entered to system	Electronic filing	Electronic filing	Electronic filing
b. Of data generated by national office	Direct input	Direct input	Direct input	Direct input
c. Of data generated by field offices	Typed input mailed to national office	Typed input mailed to national office	Direct input	Direct input
d. Of historic data	None	Some (specified in Table 4-2)	Some (specified in Table 4-2)	All (specified in Table 4-2)
2. Data edit				
a. Type	Simple (data type, field length, internal consistency)	Simple	Simple (data type, field length, internal consistency) and complex (consistency with other items in data base)	Simple and complex

TABLE 4-1, PART 2 OF 4

SYSTEM FUNCTIONS

Function	Level			
	Option 1	Option 2	Option 3	Option 4
2. Data edit, continued				
b. Frequency	Batch — weekly	Batch — weekly	Simple -- as data are entered, where applicable; weekly batch otherwise Complex — weekly batch	Simple -- as data are entered, where applicable; weekly batch otherwise Complex — weekly batch
3. Inquiry				
a. Search parameters	Index terms	Index terms	Index terms & keyword search of full text	Index terms & keyword search of full text
b. Type of items retrieved	Data values and citations	Data values and citations	Full text or image	Full text or image
c. Maximum complexity (parameters per query)	Two	Two	Four	Four
4. Management information system				
a. Case tracking/management	Current level	Current level	Analytical routines to provide early warning of problem cases	Analytical routines to provide early warning of problem cases

TABLE 4-1, PART 3 OF 4

SYSTEM FUNCTIONS

Function	Level			
	Option 1	Option 2	Option 3	Option 4
4. Management information system, continued				
b. Workload measurement	Field only; scheduled reports only	Field only; scheduled reports only	Field and OE; scheduled and ad hoc reports	Field and OE; scheduled and ad hoc reports
5. Computer targeting (including tickler for plans not filed on time)	Scheduled batch screening with ability to modify parameters and thresholds	Same as Option 1	Ad hoc screening	Ad hoc screening
6. Electronic mail	No	No	Limited	Yes
7. Teleconferencing	No	No	Yes	Yes
8. Word processing	OE	OE	OE and field offices	OE and field offices
9. Data security	Password-controlled access to specific data levels: Closed cases only Selected portions of open cases Selected open cases All cases Highly confidential information	Same as Option 1	Limited encryption	Password-controlled access to specific data levels; audit trails of unsuccessful attempts to access protected data more than a specified number of times; encryption

TABLE 4-1, PART 4 OF 4

SYSTEM FUNCTIONS

Function	Level			
	Option 1	Option 2	Option 3	Option 4
10. Workstation and printer availability	One workstation & letter-quality printer per 10 OE professional staff	One workstation & letter-quality printer per 10 OE professional staff	OE: 1) One workstation per 3 professional staff 2) Three draft-quality printers 3) Two letter-quality printers Field Offices: 1) One workstation per six professional staff members 2) One letter-quality printer per twelve professional staff members	OE: 1) One workstation per professional staff member 2) One draft-quality printer per 8 professional staff members 3) One letter-quality printer (would increase to 3 w/o electronic mail) Field offices: 1) One workstation per two professional staff members 2) One letter-quality printer per eight professional staff members

TABLE 4-2, PART 1 OF 2

DATA BASE CONTENTS

Item	Option 1	Option 2	Option 3	Option 4
1. Annual data input				
a. 5500 - equivalent information (including attachments)	All numeric, checkbox and identification data	All numeric, checkbox and identification data	All contents	All contents
b. Reports of investigation	Case characteristics, index to exhibits and index to text	All text and index to exhibits	All text and index to exhibits	All text and index to exhibits
c. Intelligence files	Items created in office and index to exhibits	Items created in office and index to exhibits	Items created in office and index to exhibits	Items created in office and index to exhibits
d. Fiduciary library	Index to advisory opinion information letters	Index to advisory opinion letters and library publications	Index to advisory opinion letters and library publications	Text of advisory opinion information letters; index to library publications
e. SPDs	Nothing	Date and identification	Date and identification	Date and identification
f. Internal policy statements/guidelines	Index by topic	Index by topic	Full text	Full text

TABLE 4-2, PART 2 OF 2

DATA BASE CONTENTS

Item	Option 1	Option 2	Option 3	Option 4
2. Historical data entered at start-up				
a. 5500 - equivalent information	None	All data on cases investigated for three years, at same level as annual input data	All data on cases investigated for six years, at same level as annual input data	All data for all past years, at same level as annual data input.
b. Reports of investigation				
c. Intelligence files				
d. Fiduciary library	None	Index to three years of advisory opinion letters and library publications	Index to six years of advisory opinion letters and library publications	Text of all past advisory opinion letters; Index to library publications
e. EBS-1s	None	All numeric, checkbox and identification data	All numeric, checkbox and identification data	All numeric, checkbox and identification data
3. Data retained in active files	Data up to 6 years old	All data on large plans; data for 4 years on small plans	All data	All data

TABLE 4-3

DATA BASE VOLUMES

Data Type	Data Volume* (Billions of Bytes**)			
	Option 1	Option 2	Option 3	Option 4
Annual data input	4	4	93	93
Historical data entered at start-up	0	***	1	820
Maximum data retained in active files	20	20	750	1600

*Not including data base indices or system overhead requirements

**Data characters

***Less than .5 billion bytes

Annually, data over six years old will be purged to off-line storage. Therefore, the total data stored on-line will never exceed 20 billion bytes. At any time, about 7 million bytes of these data (consisting of case tracking information and all indices) will be accessible for on-line inquiry. The remaining stored data need only be available for batch access.

All stored data will be accessible in batch mode for computer targeting, legislative analysis, statistical reporting, and workload measurement.

4.2 Option 2 System Operating Concept

Over its planned eight-year life, the system will have the capacity for the annual input of 82 billion bytes of data from forms in the 5500 series plus attachments. These data will arrive in the form of 850,000 submissions, of which 835,000 will arrive on one floppy disk each, 10,000 will arrive on-line and 5,000 (i.e., those too large to fit on one floppy disk) will arrive on one magnetic tape each.

The data which arrive on-line will be copied to magnetic tapes or floppy disks, as appropriate. All of the submissions will be kept on floppy disks or magnetic tape, from which printed copies will be made as needed.

Four billion bytes of numeric, checkbox and identification data will be automatically extracted from the input for on-line access. All data extracted will be edited for data type, field length, and internal consistency. The extraction process will be evenly spaced over the year.

An additional 7 million bytes of data will be generated each year at the national office in the form of indexing and case tracking information. A further million bytes of text data (intelligence file items originated at the national office) will be generated on a national office integrated word processing system and retained in the computer system. Another 45 million bytes (reports of investigation) will be generated in typed form by the 25 field offices and input to the computer by a key-to-tape or key-to-disk process.

Three word processing workstations with associated letter-quality printers will be used at the national office to generate correspondence. A draft-quality printer will be used to print 5500 data as needed.

At start-up, the system storage must be capable of holding 440 million bytes of historical data. Annually, all data over four years old on small plans will be purged to off-line storage. Therefore, the total data stored in computer-readable form will never exceed 20 billion bytes. At any time, about 7 million bytes of these data (consisting of case tracking information and all indices) must be accessible for on-line inquiry. The remaining stored data need only be available for batch access.

All stored data must be accessible in batch mode for computer targeting, legislative analysis, statistical reporting, and workload measurement.

4.3 Option 3 System Operating Concept

Over its planned eight-year life, the system must have the capacity for the annual input of 93 billion bytes of data from forms in the 5500 series plus attachments. These data will arrive in the form of 850,000 submissions, of which 835,000 will arrive on one floppy disk each, 10,000 will arrive on-line and 5,000 (i.e., those too large to fit on one floppy disk) will arrive on one magnetic tape each.

About 55% (51 billion bytes in 467,500 submissions) of the annual input will arrive in approximately one month in mid-summer (late July to early August); the arrival of the remainder will be evenly spaced over the rest of the year. All input data must be accessible for system use within one week of arrival.

The data input on-line will have simple edits (data type, field length, internal consistency) performed on-line at the time of receipt, with appropriate error messages returned to the sending system. Simple edits will be performed in a batch mode on all other data input during each week. All of each week's input data will be edited for consistency with other items in the existing data base in a weekly batch mode. During or after data input and editing, the data will be indexed. When editing has been completed, the indices will be stored on disk files and the 5500 data will be stored on magnetic tape. When a case is opened, all relevant data will be copied from magnetic tape to disk storage or other on-line storage.

An additional 45 million bytes of data will be generated each year by the 25 field offices and input to the computer by a key-to-tape or key-to-disk process. A further 23 billion bytes will be generated by OE. Most of these data will be generated at on-line workstations (10 in OE and 125 in the field offices), using an integrated word processing capacity and formatted input screens. These data will be circulated among these offices (primarily between OE and the field offices) with electronic mail and will be stored in the system data base.

Two letter-quality printers and three draft-quality printers in the national office will be used to generate reports and correspondence.

At start-up, the system storage must be capable of holding a billion bytes of historical data; in eight years, these data will total 750 billion bytes. At any time, about 3 billion bytes of these data (consisting of indices to all stored data, all case characteristics, all data on open cases) must be accessible for on-line access. The full text of these data must be available for a keyword search and 5500 data element search, which may be done in a batch mode.

All stored data must be accessible in batch mode for computer targeting, legislative analysis, statistical reporting, and workload measurement.

A limited teleconferencing system and electronic mail capability will link the OE and the field offices, with a minimum encryption capability available, on a timesharing basis.

4.4 Option 4 (Maximum) System Operating Concept

Over its planned eight-year life, the system must have the capacity for the annual input of 93 billion bytes of data from forms in the 5500 series plus attachments. These data will arrive in the form of 850,000 submissions, of which 835,000 will arrive on one floppy disk each, 10,000 will arrive on-line and 5,000 (i.e., those too large to fit on one floppy disk) will arrive on one magnetic tape each.

About 55% (51 billion bytes in 467,500 submissions) of the annual input will arrive in approximately one month in mid-summer (late July to early August); the arrival of the remainder will be evenly spaced over the rest of the year. All input data must be accessible for system use within one week of arrival.

The data input on-line will have simple edits (data type, field length, internal consistency) performed on-line at the time of receipt, with appropriate error messages returned to the sending system. Simple edits will be performed in a batch mode on all other data input during that week. All of each week's input data will be edited for consistency with other items in the existing data base in a weekly batch mode. During or after data input and editing, the data will be indexed. When editing has been completed, the indices will be stored on disk files and the 5500 data will be stored on magnetic tape. When a case is opened, all relevant data will be copied from magnetic tape to disk storage or other on-line storage.

An additional 45 million bytes of data will be generated each year by the 25 field offices, while another 23 million bytes will be generated by OE. Most of these data will be generated at on-line workstations (30 in the national office and 375 in the field offices). An integrated word processing capability and formatted input screens will be used to generate these inputs. These data will be circulated among these offices (primarily between the OE and the field offices) with electronic mail and will be stored in the system data base.

Ninety-five letter-quality printers (of which one will be in the national office) and four draft-quality printers (all in the national office) will be used to generate reports and correspondence.

At start-up, the system storage must be capable of holding 820 billion bytes of historical data; in eight years, these data will total 1,600 billion bytes. At any time, about 3 billion bytes of these data (consisting of indices to all stored data, all case characteristics, all data on open cases) must be accessible for on-line access. The indices and case characteristics (no more than 100 million bytes) must be accessible for on-line inquiry. The full text of the on-line data must be available for keyword search and 5500 data element search, which may be done in a batch mode.

All stored data must be accessible in batch mode for computer targeting, legislative analysis, statistical reporting, and workload measurement.

A dedicated teleconferencing system and electronic mail capability will link the OE and the field offices, with a full encryption capability available.

5. SYSTEM ARCHITECTURES AND LIFE CYCLE COSTS

Figures 5-1 through 5-4 show highly simplified architectures for the options outlined in this document. Tables 5-1 through 5-4 list estimated purchase and maintenance costs for all four system options. The brands and models of equipment specified were selected as examples for costing purposes; they do not constitute a recommended configuration.

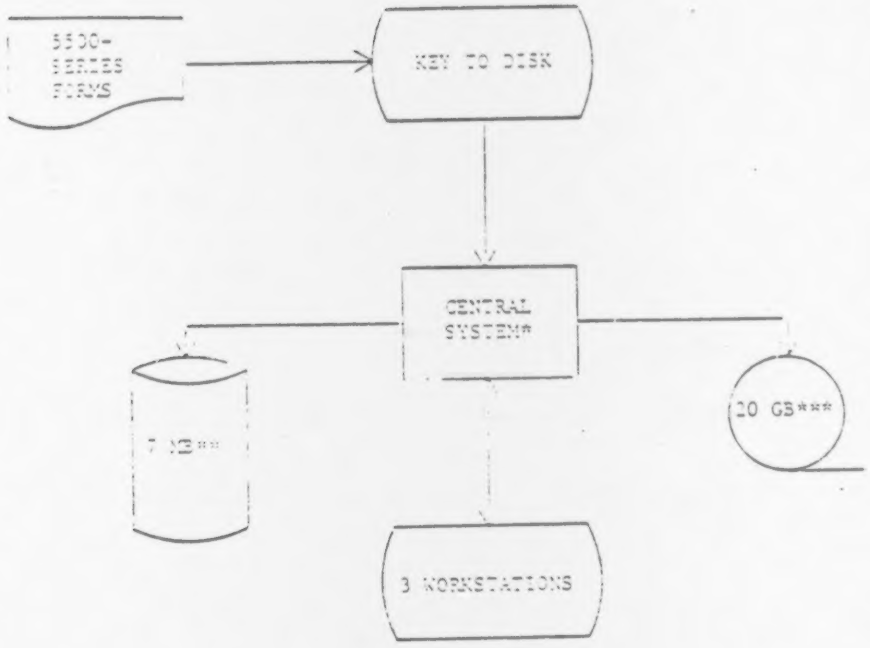
The storage capacities included in these architectures include space for data base indices and system overhead.

Commercial purchase, maintenance, and salary costs were used in these tables in order to set upper bounds on the estimates.

Facilities costs have been estimated on a very general level; they will depend on the equipment actually procured.

Table 5-5 summarizes the costs detailed in Tables 5-1 through 5-4, as well as including estimates of software development, data conversion and annual operations costs. It is important to note the impact of manual data entry (i.e., key entry) on the Option 1 annual operating cost, as compared with those for Options 2, 3 and 4, which are all based on electronic filing.

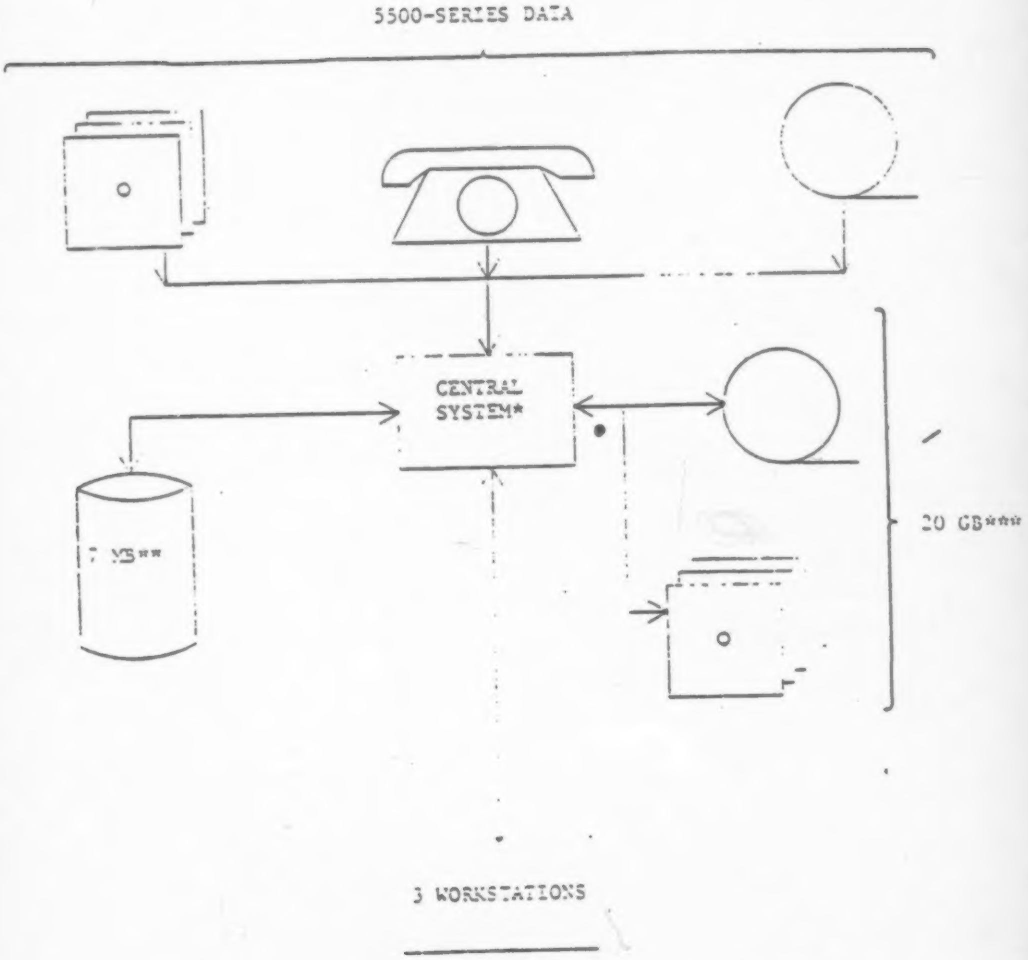
Similarly, the cost of key entry of all historical data for Option 4 indicates that the entry of this volume of text data is not practical. While optical character recognition (OCR) technology could be used for this purpose, the scope of the system required (a two-shift operation of about a hundred optical readers for two years plus key entry of the 10-15 percent of the data which would not be machine-readable) make it unfeasible as well as still very costly (over $200 million).


5500-
SERIES
FORMS
KEY TO DISK
CENTRAL
SYSTEM*
7 MB**
20 GB***
3 WORKSTATIONS

*Computer hardware and software
**MB = megabyte (1 million bytes)
***GB = gigabyte (1 billion bytes)

FIGURE 5-1

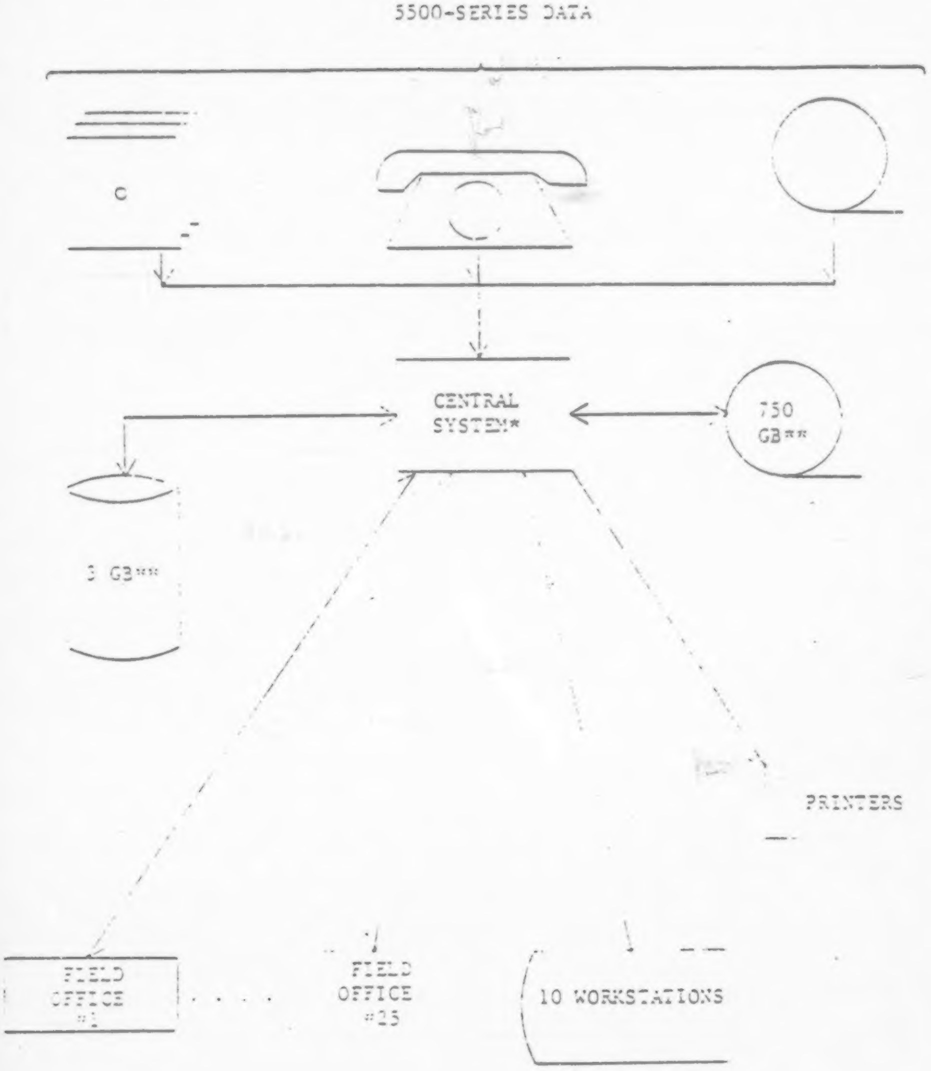
SYSTEM ARCHITECTURE DESIGN
FOR OPTION 1


5500-SERIES DATA
CENTRAL SYSTEM*
7 MB**
20 GB***
3 WORKSTATIONS

*Computer hardware and software
**MB = megabyte (1 million bytes)
***GB = gigabyte (1 billion bytes)

FIGURE 5-2

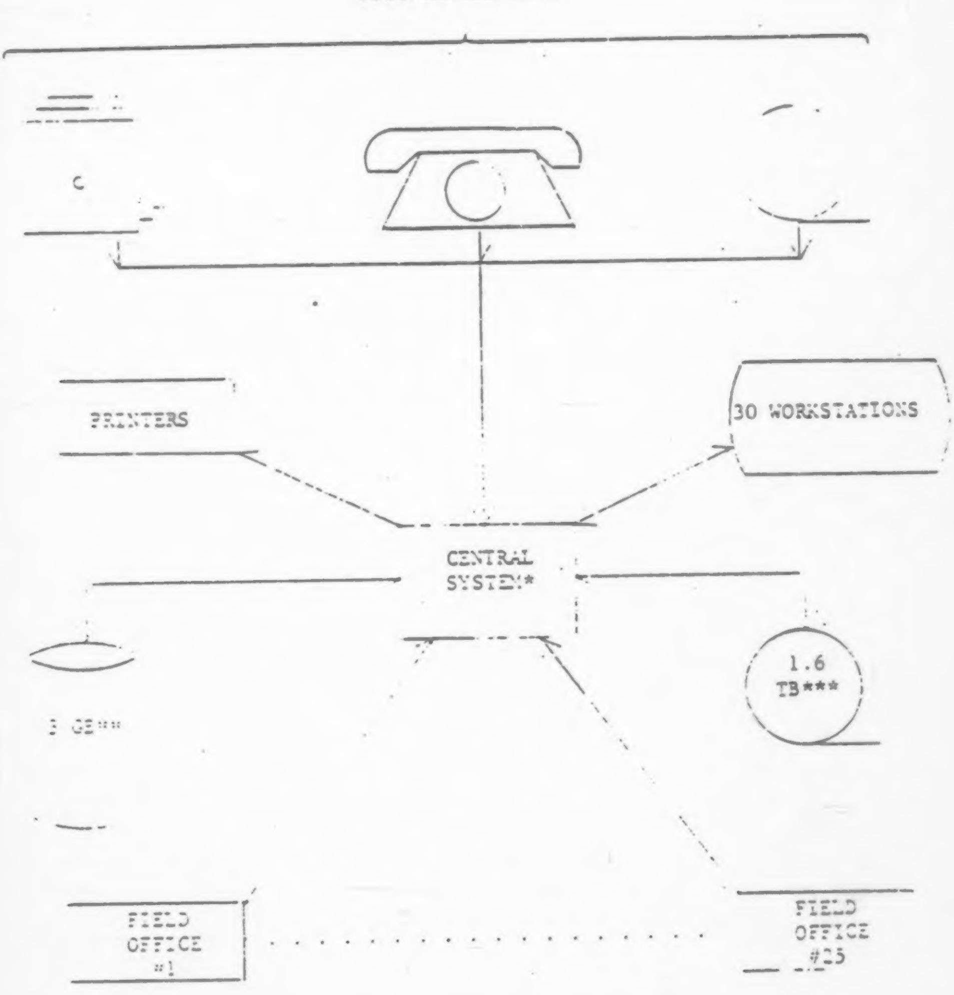
SYSTEM ARCHITECTURE DESIGN
FOR OPTION 2


5500-SERIES DATA
C
CENTRAL SYSTEM*
750 GB**
3 GB**
PRINTERS
FIELD OFFICE #1
. . . .
FIELD OFFICE #25
10 WORKSTATIONS

*Central computer hardware and software
**GB = gigabyte (1 billion bytes)

FIGURE 5-3

SYSTEM ARCHITECTURE DESIGN
FOR OPTION 3


5500-SERIES DATA
PRINTERS
30 WORKSTATIONS
CENTRAL SYSTEM*
3 GB**
1.6 TB***
FIELD OFFICE #1
FIELD OFFICE #25

*Central computer hardware and software
**GB = gigabyte (1 billion bytes)
***TB = terabytes (1 trillion bytes)

FIGURE 5-4

SYSTEM ARCHITECTURE DIAGRAM
FOR OPTION -

TABLE 5-1
ESTIMATED SYSTEM COST FOR OPTION 1

	Purchase Cost	Monthly Maint.
Hardware		
(1) IBM #4341 Processor Model Group 1 (K1)	$184,500	541
(1) Operator's Console #3278 Display Console Model 2A	2,505	57
(6) Workstations #8775 (Approximately $2,000 ea)	12,000	102
Direct Access System Disk #3380 (1) Model A04	86,310	285
(1) Storage Control Unit #3880 Model 13	179,950	576
(3) Letter quality printers #3284 ($2,425 ea)	7,275	156
(1) Magnetic Tape Drive #3430 Model A01	33,400	235
(1) Magnetic Tape Control Unit #3803 Model 2 (6250/1600 bpi)	27,550	178
(200) Magnetic Tapes @ $25 ea	5,000	N/A
Total Hardware	538,490	2,130
Software		
Operating System	1800/mo.	N/A
DBMS (DB2), Utilities	25,000	N/A
Word Processing	1,500	N/A
Total Software Purchase	26,500	-
Total Software Lease	1800/mo.	-

TABLE 5-1 (CONCLUDED)
ESTIMATED SYSTEM COST FOR OPTION 1

	Purchase Cost	Monthly Maint.
Salaries (Assuming 100% Overhead)		
(1) Systems Programmer @ $100,000/yr.	100,000/yr.	
(2) Applications Programmers @ $60,000/yr.	120,000/yr.	
(2) Computer Operators @ $30,000/yr.	60,000/yr.	
Total Salaries	280,000/yr.	
Facilities		
Site Preparation (GSA)	75,000	
Space Requirements	TBD	

TABLE 5-2
ESTIMATED SYSTEM COST FOR OPTION 2

	Purchase Cost	Monthly Maint.
Hardware		
(1) IBM #4341 Processor model Group 1 (K1)	$184,500	541
(1) Operator's Console #3278 Display Console Model 2A	2,505	57
(9) Workstations #8775 (Approximately $2,000 ea)	18,000	153
Direct Access System Disk #3380		
(1) Model A04 $86,310 ea.	86,310	285
(2) Model B04 $71,600 ea.	143,200	480
(1) Storage Control Unit #3880 Model 13	179,950	576
(3) Letter quality printers #3284 ($2,425 ea)	7,275	156
(2) Magnetic Tape Drive #3430 Model A01	66,800	470
(1) Magnetic Tape Control Unit #3803 Model 2 (6250/1600 bpi)	27,550	178
(200) Magnetic Tapes @ $25 ea	5,000	N/A
(1) Diskette Magazine Unit #4966 ($6,160 ea)	6,160	39
(1) Adapters for Diskette Magazine Unit #4965 ($6,635 ea)	6,635	18
Total Hardware	733,885	2,953

TABLE 5-2 (CONCLUDED)
ESTIMATED SYSTEM COST FOR OPTION 2

	Purchase Cost	Monthly Maint.
Software		
Operating System	1800/mo.	N/A
DBMS (DB2), Utilities	50,000	N/A
Word Processing	1,500	N/A
Total Software Purchase	51,500	-
Total Software Lease	1800/mo.	-
Salaries (Assuming 100% Overhead)		
(1) Systems Programmer @ $100,000/yr.	100,000/yr.	
(3) Applications Programmers @ $60,000/yr.	180,000/yr.	
(2) Computer Operators @ $30,000/yr.	60,000/yr.	
Total Salaries	340,000/yr.	
Facilities		
Site Preparation (GSA)	85,000	
Space Requirements	TBD	

TABLE 5-3
ESTIMATED SYSTEM COST FOR OPTION 3

	Purchase Cost	Monthly Maint.
Hardware		
(1) IBM #4381 Processor Model Group 1 (4MB Main Storage)	370,000	564
(1) Operator's Console #3278 Display Console Model 2A	2,505	19
Direct Access System Disk #3380		
(2) Model A04 $86,310 ea	172,620	285
(3) Model B04 $71,600 ea	214,800	720
(1) Storage Control Unit #3880 Model 13	179,950	576
(6) Magnetic Tape Drives Model #3430		
(1) Model A01 $33,400 ea	33,400	235
(3) Model B01 $16,900 ea	50,700	495
(1) Magnetic Tape Control Unit #3803 Model 2 (6250/1600 bpi)	27,550	178
(7,500) Magnetic Tapes @ $25	187,500	N/A
(1) Diskette Magazine Unit #4966 $6,160 ea	6,160	39
(1) Adapter for Diskette Magazine Unit #4965 $6,635 ea	6,635	18
(135) Workstations #8775 (Approximately $2000 ea)	270,000	4,050
(64) Letter Quality Printers #3284 $2,425 ea	155,190	156
(2) Draft Quality Printers #3287 Model 2 (120cps) ($5150 ea)	10,300	93

TABLE 5-3 (CONCLUDED)
ESTIMATED SYSTEM COST FOR OPTION 3

	Purchase Cost	Monthly Maint.
Hardware, continued		
(1) High Speed Printer #3211 (2000 lpm)	40,080	952
(1) Printer Control Unit #3811	17,685	123
(1) Interchangeable Train Cartridge Unit #3216	11,600	206
(26) Modems #3863 $2,685 ea	69,810	221
(1) Communications Controller #3704 Model A4 (64K)	24,455	217
Encryption	25,000	375
Total Hardware	1,874,935	19,044
Communications, including teleconferencing	1,380,000/yr.	N/A
Software		
Operating System	1800/mo.	N/A
DBMS-IDMS/DC (Approximate)	175,000	N/A
Word Processing, Utilities, ALC Assembler, Communications	5,000	N/A
Encryption	2,000	TBD
Total Software Purchase	182,000	30
Total Software Lease	1800/mo.	-
Salaries		
(1) Systems programmer @ $100,000/yr.	100,000/yr.	
(3) Applications programmers @ $60,000/yr.	180,000/yr.	
(3) Operators @ $30,000/yr.	90,000/yr.	
Total Salaries	370,000/yr.	
Facilities		
Site Preparation (GSA)	90,000	
Space Requirements	TBD	

TABLE 5-4
ESTIMATED SYSTEM COST FOR OPTION 4

Hardware	Purchase Cost	Monthly Maint.
(1) IBM #4381 Processor Model Group 1 (4MB Main Storage)	370,000	564
(1) Operator's Console #3278 Display Console Model 2A	2,505	19
Direct Access System Disk #3380		
(2) Model A04 $86,310 ea	172,620	285
(6) Model B04 $71,600 ea	429,600	1,440
(1) Storage Control Unit #3880 Model 13	179,950	576
(6) Magnetic Tape Drives Model #3430		
(2) Model A01 $33,400 ea	66,800	470
(4) Model B01 $16,900 ea	67,600	660
(1) Magnetic Tape Control Unit #3803 Model 2 (6250/1600 bpi)	27,550	178
(16,000) Magnetic Tapes @ $25	400,000	N/A
(2) Diskette Magazine Units #4966 $6,160 ea	12,320	77
(2) Adapters for Diskette Magazine Units #4965 $6,635 ea	13,270	36
(405) Workstations #8775 (Approximately $2000 ea)	810,000	12,150
(95) Letter Quality Printers #3284 $2,425 ea	230,375	4,940
(4) Draft Quality Printers #3287 Model 2 (120cps) ($5150 ea)	20,600	186
(1) High Speed Printer #3211 (2000 lpm)	40,080	952

TABLE 5-4 (CONCLUDED)
ESTIMATED SYSTEM COST FOR OPTION 4

	Purchase Cost	Monthly Maint.
Hardware, continued		
(1) Printer Control Unit #3811	17,685	123
(1) Interchangeable Train Cartridge Unit #3216	11,600	206
(50) Modems #3863 $2685 ea	135,250	425
(1) Communications Controller #3704 Model A4 (64K)	24,455	217
Encryption	50,000	750
Total Hardware	3,083,260	24,254
Communications, including tele-conferencing	3,515,040/yr.	N/A
Software		
Operating System	1800/mo.	N/A
DBMS-IDMS/DC (Approximate)	175,000	N/A
Word Processing, Utilities, ALC Assembler, Communications	8,000	N/A
Encryption	2,000	30
Total Software Purchase	185,000	30
Total Software Lease	1800/mo.	-
Salaries		
(1) Systems programmers @ $100,000/yr.	100,000/yr.	
(4) Applications programmers @ $60,000/yr.	240,000/yr.	
(3) Operators @ $30,000/yr.	90,000/yr.	
Total Salaries	430,000/yr.	
Facilities		
Site Preparation (GSA)	100,000	
Space Requirements	TBD	

TABLE 5-5

SUMMARY OF ESTIMATED COSTS

Type of Cost	Cost (Thousands of Dollars)			
	Option 1	Option 2	Option 3	Option 4
One-time:				
Hardware	538	734	1,875	3,083
Software purchase	27	52	182	185
Software development	860	960	1,240	1,380
Historical data conversion	-	6	1,530	1,230,090
Tracking data conversion	20	20	20	20
Site preparation	75	85	90	100
Total	1,520	1,857	4,937	1,234,858
Annual:				
Software lease	22	22	22	22
Communications	-	-	1,380	3,515
Operations	280	340	370	430
Key entry	4,000*	500	500	500
Maintenance	26	35	115	491
Total	4,328	897	2,587	4,958
System life-cycle cost (8-year system life)	36,144	9,033	25,633	1,274,522

*Without an electronic filing capability, a significant data entry effort will be required to support the enforcement system.

The use of an indexed digitized image system would reduce the coversion cost to about $15 million, but the stored data would not be retrievable as text (i.e., no keyword searches could be done). More sophisticated terminals would be needed to display the stored images and the image data would require considerably more storage space then the equivalent text.

6. IMPLEMENTATION SCHEDULES

Figures 6-1 through 6-4 show estimated implementation schedules for options 1 through 4 respectively. Estimates of staff resources for the implementation tasks are also included where appropriate. These estimates do not include key entry staffing for historical data conversion, as it is assumed that this function would be costed by data volumes (as reflected in Table 5-5). Not all tasks are applicable to all system options; for example, option 1 has no teleconferencing system.

Task	Staff Months
Define detailed functional requirements, including data	12
Conduct sizing study	4
Conduct feasibility study (technology assessment)	1
Conduct communications study	N/A
Develop system design	4
Develop program design	5
Develop Request for Proposal (RFP)	4
Obtain GSA approval	2
Vendors prepare proposals	-
Develop evaluation methodology	4
Evaluate proposals and select contractor	6

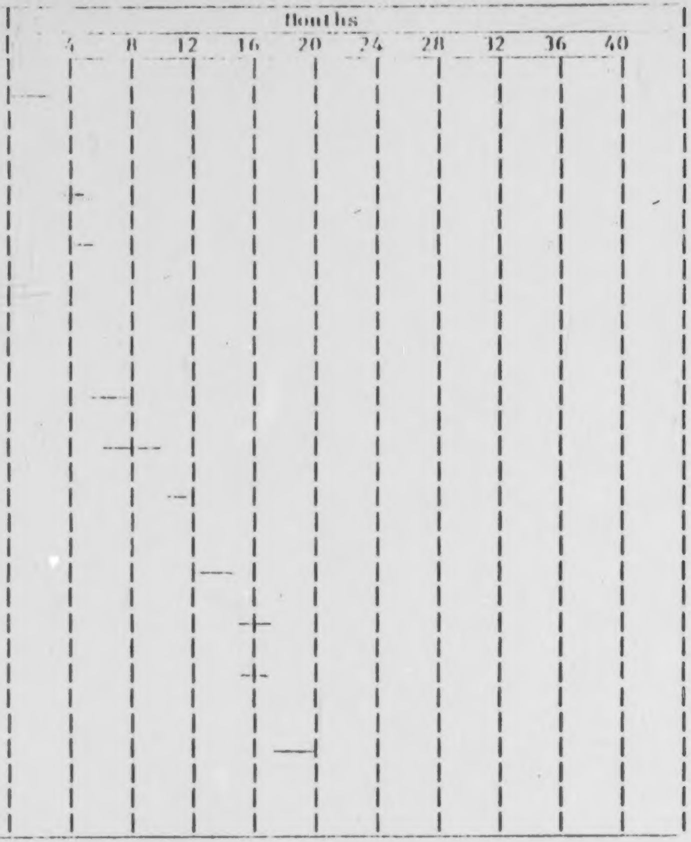


FIGURE 6-1, PART 1 OF 2

ESTIMATED IMPLEMENTATION SCHEDULE AND STAFFING FOR OPTION I

Task	Staff Months
Develop applications software (including documentation)	24
Install computer system hardware	2
Install systems software	2
Install communications hardware and software	N/A
Install applications software	2
Convert historical data	N/A
Convert current case tracking system	8
Run acceptance tests	2
Prepare training program	2
Train users	2
Run parallel operation	
Procure and install teleconferencing system	N/A

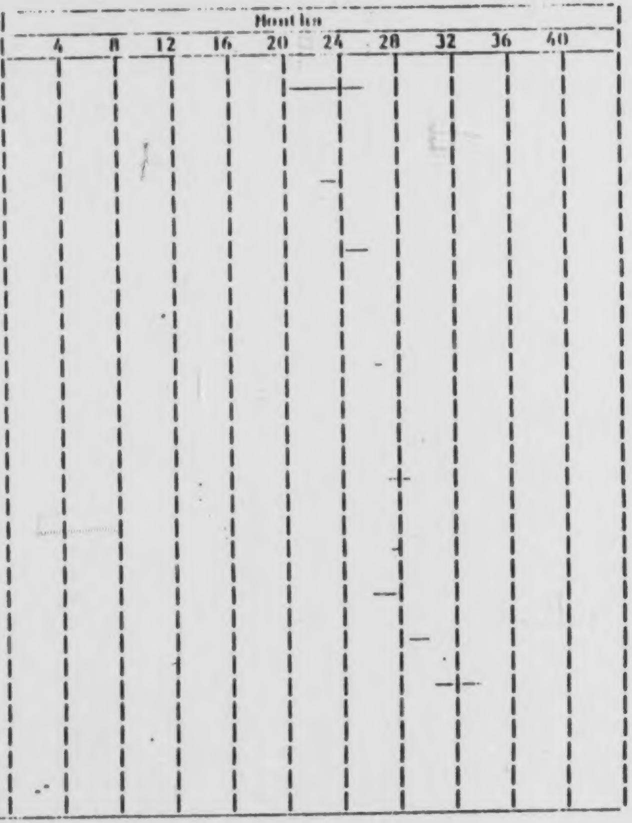
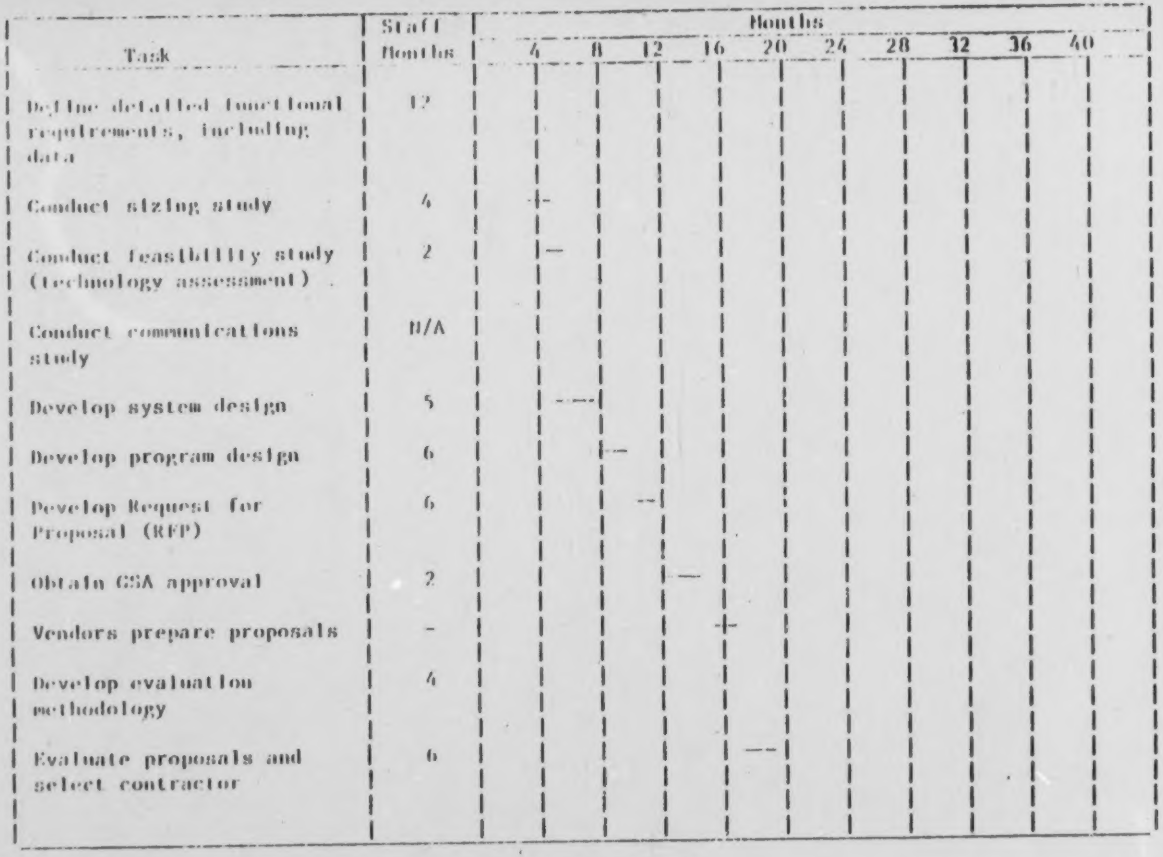


FIGURE 6-1, PART 2 OF 2

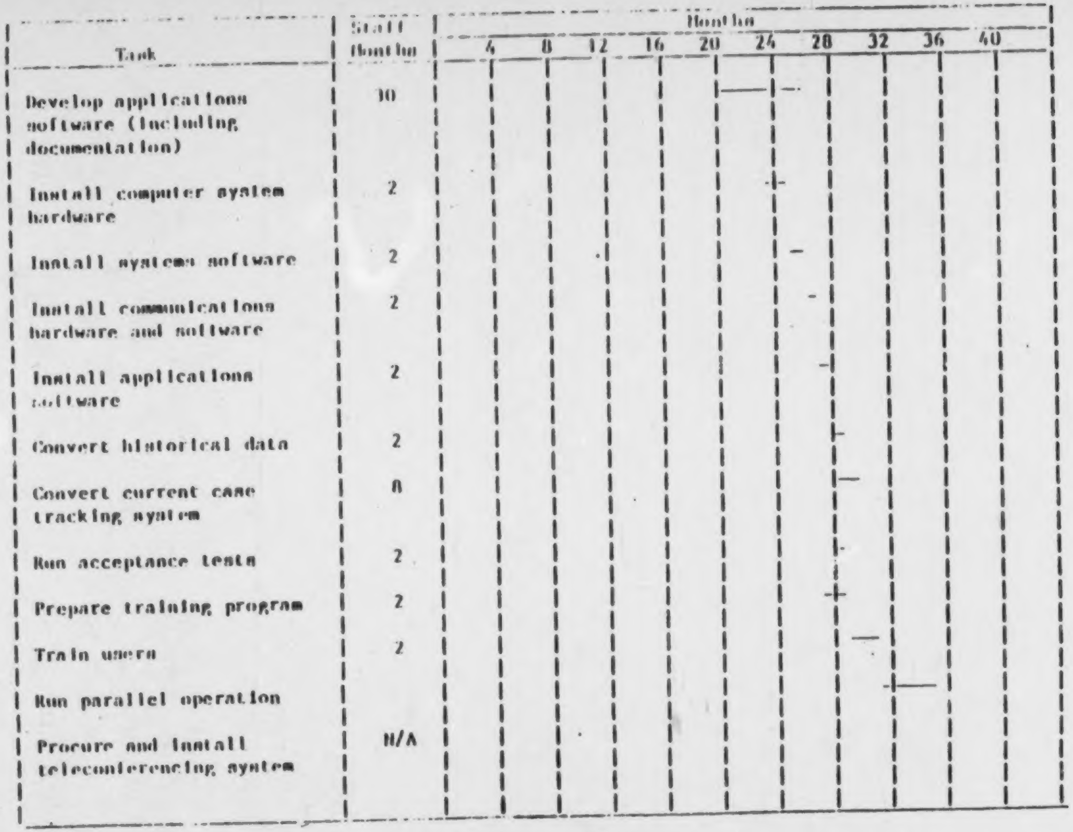
ESTIMATED IMPLEMENTATION SCHEDULE AND STAFFING FOR OPTION 1



Task	Staff Months	Months: 4	8	12	16	20	24	28	32	36	40
Define detailed functional requirements, including data	12										
Conduct sizing study	4										
Conduct feasibility study (technology assessment)	2										
Conduct communications study	N/A										
Develop system design	5										
Develop program design	6										
Develop Request for Proposal (RFP)	6										
Obtain GSA approval	2										
Vendors prepare proposals	-										
Develop evaluation methodology	4										
Evaluate proposals and select contractor	6										

FIGURE 6-2, PART 1 OF 2

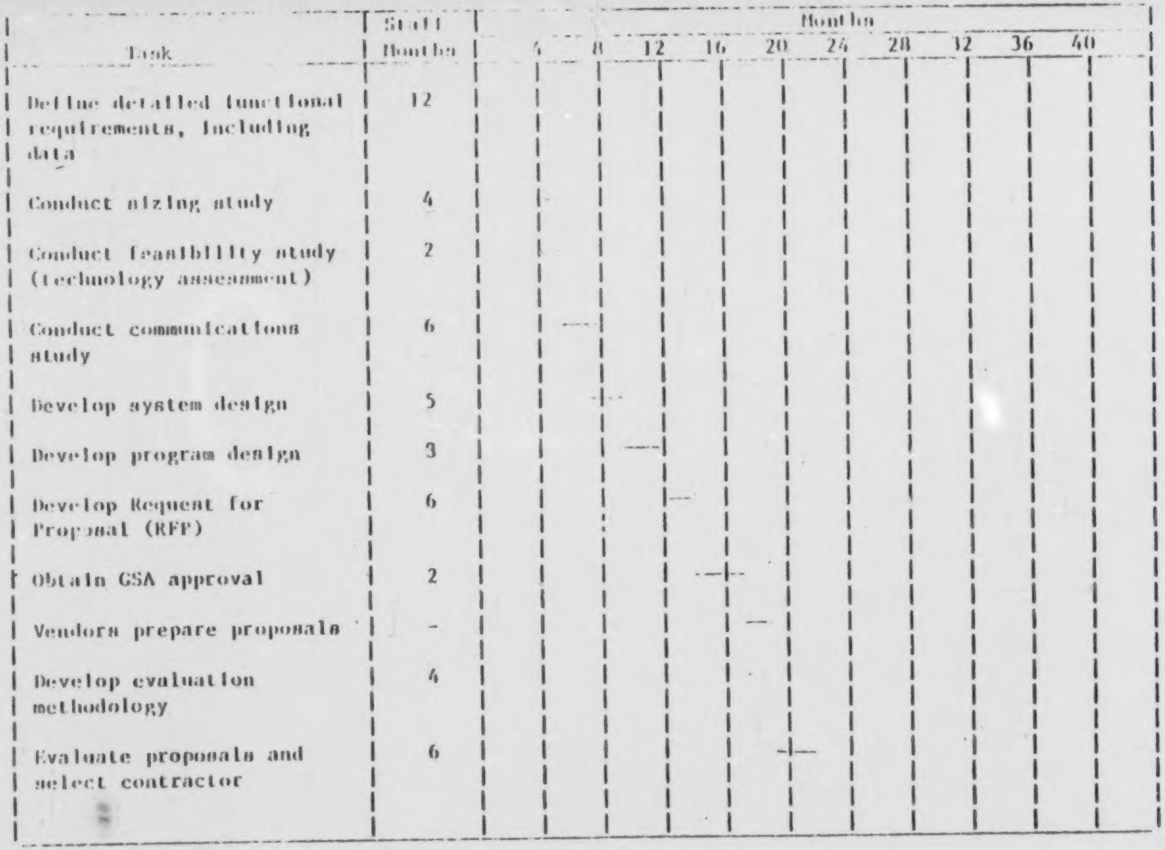
ESTIMATED IMPLEMENTATION SCHEDULE AND STAFFING FOR OPTION 2



Task	Staff Months
Develop applications software (including documentation)	10
Install computer system hardware	2
Install systems software	2
Install communications hardware and software	2
Install applications software	2
Convert historical data	2
Convert current case tracking system	8
Run acceptance tests	2
Prepare training program	2
Train users	2
Run parallel operation	
Procure and install teleconferencing system	N/A

FIGURE 6-2, PART 2 OF 2

ESTIMATED IMPLEMENTATION SCHEDULE AND STAFFING FOR OPTION 2



Task	Staff Months
Define detailed functional requirements, including data	12
Conduct sizing study	4
Conduct feasibility study (technology assessment)	2
Conduct communications study	6
Develop system design	5
Develop program design	3
Develop Request for Proposal (RFP)	6
Obtain GSA approval	2
Vendors prepare proposals	-
Develop evaluation methodology	4
Evaluate proposals and select contractor	6

FIGURE 6-3, PART 1 OF 2

ESTIMATED IMPLEMENTATION SCHEDULE AND STAFFING FOR OPTION 3

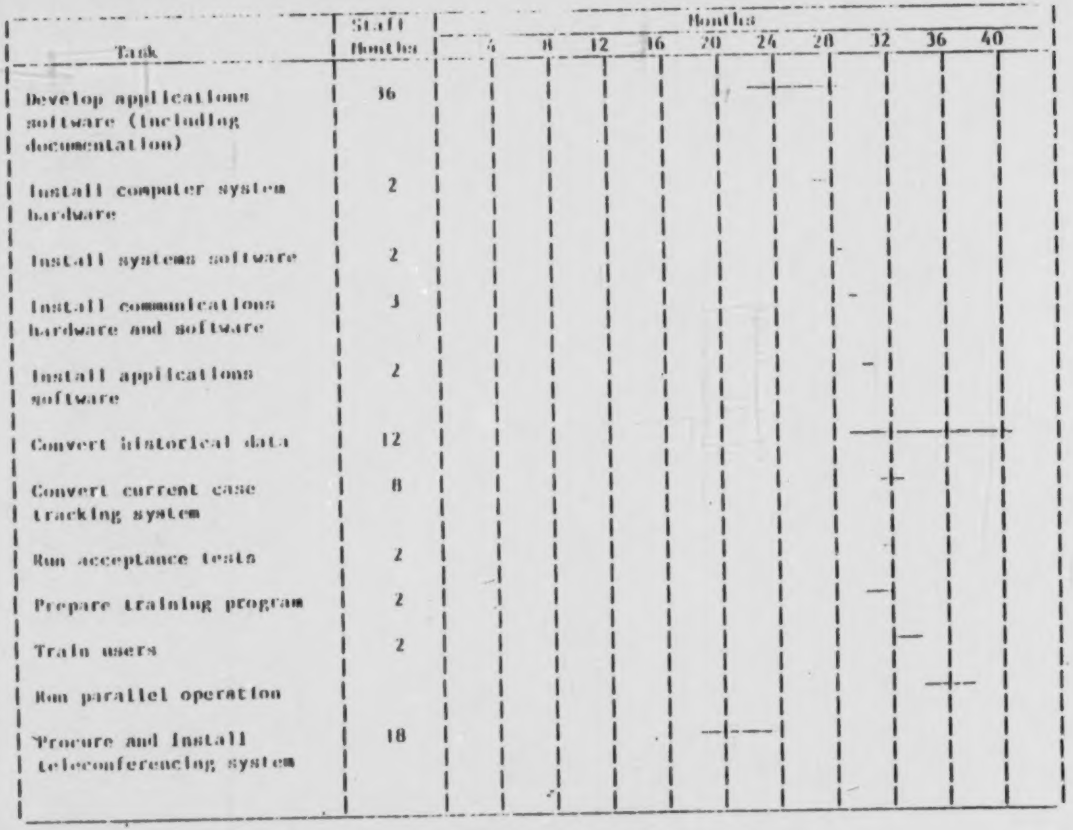
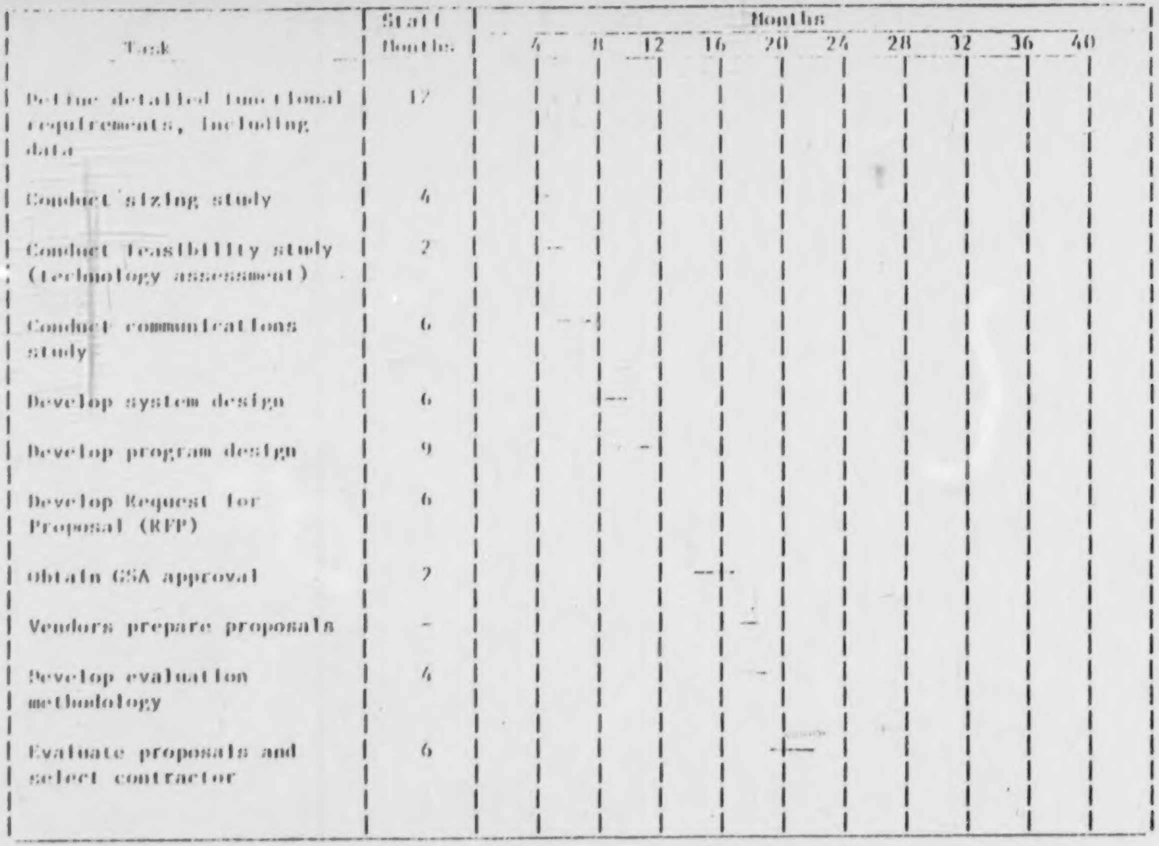


FIGURE 6-1, PART 2 OF 2

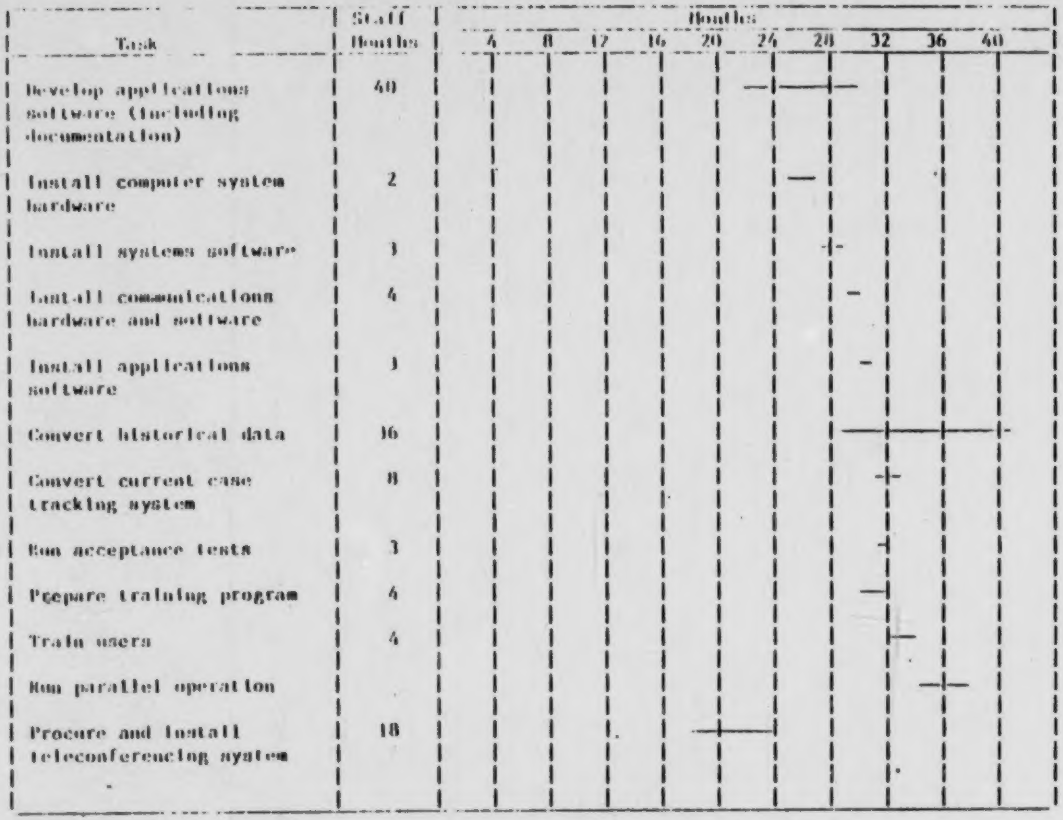
ESTIMATED IMPLEMENTATION SCHEDULE AND STAFFING FOR OPTION 3



Task	Staff Months
Define detailed functional requirements, including data	12
Conduct sizing study	4
Conduct feasibility study (technology assessment)	2
Conduct communications study	6
Develop system design	6
Develop program design	9
Develop Request for Proposal (RFP)	6
Obtain GSA approval	2
Vendors prepare proposals	-
Develop evaluation methodology	4
Evaluate proposals and select contractor	6

FIGURE 6-4, PART 1 OF 2

ESTIMATED IMPLEMENTATION SCHEDULE AND STAFFING FOR OPTION 4



Task	Staff Months
Develop applications software (including documentation)	40
Install computer system hardware	2
Install systems software	3
Install communications hardware and software	4
Install applications software	3
Convert historical data	16
Convert current case tracking system	8
Run acceptance tests	3
Prepare training program	4
Train users	4
Run parallel operation	
Procure and install teleconferencing system	18

FIGURE 6-4, PART 2 OF 2

ESTIMATED IMPLEMENTATION SCHEDULE AND STAFFING FOR OPTION 4

ATTACHMENT 3

ERISA ENFORCEMENT OPTIONS FOR DATA PROCESSING AND INFORMATION HANDLING

July 26, 1984

Introduction

This paper is intended as an OPWBP staff analysis of Technical Memorandum prepared by MITRE Corporation dated July 24, 1984. The staff analysis was performed in order to place the Technical Memorandum in the overall context of OPWBP and to make a specific recommendation.

I. Background

Since the enactment of the Employee Retirement Income Security Act (ERISA) in 1974, the Department of Labor has received literally tens of millions of data elements in regard to the Department's ERISA enforcement and compliance programs. These data are a result of the annual reporting requirements, field investigations, intelligence gathering and shared information from other Agencies.

In March 1984, the OPWBP Administrator, Robert A.G. Monks, constituted an ERISA Enforcement Working Group to review all phases of OPWBP's enforcement activity and to recommend changes. One aspect of the review regards the receipt, collection, tabulation and utilization of enforcement data and information using automated technology.

In order to objectively study the vast array of data processing options available, a systems analysis and systems engineering expert was obtained. The MITRE Corporation was hired by OPWBP to conduct the survey and to present a range of data processing options from a minimum system configuration to a maximum system.

The MITRE work product is a "Technical Memorandum" (copy attached) which focuses on the establishment and use of an in-house data base and processing system for ERISA enforcement. The MITRE Technical Memorandum contains four options, each of which is composed of numerous sub-parts.

II. Summary of MITRE Technical Memorandum

MITRE's work began with a series of meetings with OPWBP staff. The types and volume of data available were identified. The operational needs and requirements of OPWBP enforcement were then studied. From these meetings, MITRE developed an operating concept of hardware and software architecture for an optimum systems configuration. The optimum systems configuration was designed without constraints regarding costs.

On the other end of the spectrum MITRE designed a minimum systems configuration. The minimum configuration is defined to mean that system level below which automated technology is no longer cost effective.

Two intermediate systems are configured by MITRE to demonstrate practical functional support by combining and modifying the two extreme systems. Each system configured in the MITRE report contains numerous sub-elements so that a large number of recombinations exist for consideration.

III. OPWBP Staff Analysis or Options

The MITRE Technical Memorandum has been subjected to comprehensive review and analysis of OPWBP senior staff. The staff review goal was to evaluate the MITRE options and sub-elements in order to configure and recommend the most efficient, desirable, practical and realistic system.

Staff determined that each of the MITRE options contained meritorious elements but that none of the four options were acceptable as configured in the Technical Memorandum. This finding does not discredit the MITRE work, but merely results from additional considerations not available or used by MITRE such as cost effectiveness, level of training needed by operating personnel, perceived enforcement needs, and anticipated future enforcement policy. As a practical matter MITRE only considered a few basic options without the intent to limit the ultimate OPWBP decision to these specific options.

IV. Technical and Program Considerations Used for OPWBP Staff Analysis

The OPWBP staff analysis used the MITRE work product as a primary input, but the staff analysis also gives consideration to overall OPWBP policies and initiatives. Generally, the OPWBP policies considered were those which will enhance and emphasize the enforcement role of OPWBP. The anticipated staff and budget enhancements for OPWBP were factors in this analysis. The initiatives that were generally considered as factors include electronic filing of annual reports and the automated information handling system designed to link all national office and field office staff.

In addition to these forward looking considerations, the staff analysis also considered the current needs for OPWBP. An examination of the current needs and current data/information availability discloses that there exists a wealth of ERISA data and information in raw form. The ability to perform comprehensive analysis and to disseminate data/information to staff is the current problem. The raw data/information takes the form of computer tapes received from IRS. These tapes contain tens of millions of data elements regarding the financial status of all plans in the OPWBP universe (except master trusts and the like). Although the tapes contain only partial data on any individual plan, the data available do provide a rich source of enforcement relevant information.

OPWBP's processing of these IRS computer tape data has only scratched the surface. Although important data processing has been performed by OPWBP, the program does not yet have a fully staffed unit to support the large data processing tasks necessary to completely realize the value of current data.

The dissemination of the computer work now being done also degrades the program's utilization of currently available data. Dissemination from the national office to the field is dependent on paper copies. The paper copy modality includes all attendant problems associated with making photocopies and mailing bulky computer printouts.

In summary, the current needs of OPWBP are not served in large part due to the lack of a staffed data processing unit, the inability to quickly and easily disseminate computer extracts and reports, and the lack of critical data elements due to IRS's partial data entry from ERISA Annual Reports.

The near-term future of OPWBP includes three initiatives which are considered to be important factors in making the staff recommendation which follows in this paper.

The first is the creation of a staff unit of data processing personnel. This unit will be totally dedicated to OPWBP data processing support. Both new systems design and existing systems maintenance will be performed by this unit.

The second is the electronic filing of ERISA data. This initiative alone will result in a tremendous leap forward in OPWBP's enforcement ability. The electronic filing results in all annual report data becoming available for analysis quickly. The annual reports will be filed by plan administrators (or their agents) in machine readable form. The ~~months of~~ delay for data reduction by IRS and for microfiching are eliminated. Electronic filing will also allow the OPWBP enforcement program a much greater period of time to target cases and perform investigations before statutory limitations on actions bars action by OPWBP.

The third is the OPWBP office automation initiative which will result in easy computer access to every OPWBP professional, national office and field. The computer network linking all OPWBP personnel will allow staff to access and query the OPWBP computer at will.

With these background facts, initiatives, and technical considerations in mind, the following system configuration is suggested.

V. Proposed OPWBP Configuration

The proposed OPWBP configuration should have the following general functional abilities:

a. all annual report data for the most recent three (3) years after system implementation.

b. accept electronic filing by majority of ERISA filers but also accommodate manual filings.

c. make all annual report data available for access within one week of receipt except for annual reports received in hard copy format.

d. perform series of edit checks automatically on incurring data generating error lists, error letters and indexes.

e. link the National OPWBP office with field for electronic mail.

f. give every OPWBP enforcement professional real time access to data indexes and batch access to annual report data, intelligence files, and related data.

g. provide word processing with letter quality printers.

h. provide keyword search of text and provide multiple levels of cross-tabulations for numeric extractions.

i. provide encryption on demand for data transfers between work stations.

j. provide reasonable communication lines between field offices and main frame through dial-up telephone lines (non-dedicated). Reasonable means that successful terminal to computer link-up must routinely occur on the first dial-up attempt.

k. provide main frame (data base) access 24 hours per days, 5 days per week with data base input limited to an 11 hour core period.

l. use a shared large main frame to reduce costs.

m. use a moderate local mini-computer for network control.

These functional abilities are equivalent to "Option 3" of the MITRE Technical Memorandum with the following major exceptions:

a. main frame hardware is leased rather than purchased.

b. main frame hardware is not totally dedicated but is a shared facility.

c. historical data conversion is limited to three (3) years.

d. Communications lines are shared with voice telephone requirements rather than leased dedicated lines.

This modified "Option 3" results in the following summary of estimated costs:

ITEM	MITRE Option 3 Costs ($000's)	Modified Option 3 Costs (000's)
One-Time:		
Hardware	1,875	0
Software purchase	182	182
Software development	1,240	1,240
Historical data conversion	1,530	800
Tracking data conversion	20	20
Site preparation	90	10
TOTAL:	4,937	2,252
Annual:		
Hardware lease/fee	0	300
Software lease	22	22
Communications	1,280	50
Operations	370	370
Key entry	500	500
Maintenance	115	15
TOTAL:	2,387	1,257
8 year system life-cost:	24,033	13,308

VI. Recommendation

The recommendation of the undersigned is the "Option 3" of the Technical Memorandum as modified herein principally through the use of a shared main frame, non-dedicated communication lines and less historical data. The modified Option 3 presented is fully capable of future upgrades to a dedicated main frame and dedicated communication lines when program requirements dictate.

Mervyn A. Schwedt
7/26/84
Date

Richard Ippolito
7/26/84
Date

SUMMARY OF CURRENT PROGRAMS AND ORGANIZATIONAL STRATEGY AND PLANNING OF PROGRAMS WITHIN THE OFFICE OF PENSION AND WELFARE BENEFIT PROGRAMS, U.S. DEPARTMENT OF LABOR

Background

In a memo of September 7, 1984 the Administrator of the Office of Pension and Welfare Benefit Programs (OPWBP) directed all Assistant Administrators to develop a long term plan for their respective divisions. The strategic planning exercise, covering a period of approximately five years, was intended to provide a comprehensive statement of current program direction and organizational strategy while lending additional coherence to the disparate initiatives which OPWBP is now undertaking.

In the initial instructions, the Administrator articulated several "modalities" which identified general goals and operating characteristics toward which planning should be directed. These included the need for increased professionalism, the importance of establishing a means to ensure continuity of policy, the requirement for non-partisanship, and a desire to improve public access and expand the scope of activities.

Further instructions delineating an objectives based planning model and a format for the presentation of plans were provided in a follow-up memo. These directed each program office to define current functions, describe an ideal or fully functional program and enunciate a set of objectives with a program design to achieve them. Planning periods were defined as threefold, the short term (FY 1985), the intermediate (FY 1986) and long term (through FY 1989). To the extent possible and relevant, objectives were to be defined for each period.

The process of plan development included a number of discussions between program managers, the Administrator and Deputy Administrators during which proposals were refined and reconciled for internal consistency. A set of plans articulating projections of OPWBP's activities over the ensuing five year period are presented in the following document. A summary of major points is provided in the remainder of this section, followed by the instructions and sections addressing the detailed plans for each of the organizational divisions of OPWBP.

MAJOR ISSUES SUMMARY

In addition to the specific concerns of each program division, the planning process focused on a number of cross cutting issues integral to all of the aspects of OPWBP's programs. These were primarily associated with issues arising from the establishment of OPWBP as a separate organizational component within the Department of Labor. This resulted in requirements to develop a means to integrate the range of activities and provide administrative and management systems to ensure its ability to operate in an optimal manner. Examination of these issues lead to the identification of the need for further organization changes and emphasis on several critical areas outlined below.

Policy Development and Review

Ongoing policy development requires input from all of the program divisions to function effectively. This requires a mechanism to integrate the economic (research) and legal (enforcement and regulatory) policy inputs. Review of this issue resulted in a determination that a more extensive policy development and review process is required and that this should operate in a manner which provides for greater interaction with the program divisions. This would involve an enhancement of the current policy group, which would remain in the same position organizationally but would receive greater direction from the Administrator's office.

Administration and Management

In the reorganization of LMSA, several administrative functions were consolidated into the National Capital Area Service Center (NCSC). While this arrangement is able to fulfill some requirements, the need for in-house expertise in budget, planning, personnel and procurement remains due to the program specific nature of some aspects of the functions. It was determined that this function should be performed on an agency wide basis under the aegis of the Deputy Administrator for Program Operations, requiring the establishment of an Administration and Management Unit in the Office of the Administrator.

Professional Competencies and Training

There is currently a mismatch between staff capabilities and position requirements in a number of areas. This is partially a consequence of the reorganization, in which some staff were moved to positions for which they had no prior experience. In the main, however, it is perceived to be a consequence of the rapid evolution of the requirements of the program which has proceeded at a faster pace than the enhancement of staff competencies. This perception led to a determination that an agency wide evaluation of skills and a major training initiative is required.

Automated Data Processing

The single underlying theme running throughout the planning process was the need to modernize program operations through office automation efforts and the importance of an accessible electronic database. These two initiatives provide a means to integrate all of OPWBP's program and are central to nearly all effectiveness improvement efforts. As a result, these projects were afforded the highest priority.

ORGANIZATIONAL DIVISION SUMMARIES

Operating plans developed by each division are presented utilizing the objectives based format. This was more applicable to the activities of some divisions than others resulting in some degree of variation in the presentation of plans. Variation also is evident in the specificity of plans. Divisions foreseeing less change in structure and operation provide more detail in the plans. Others, projecting a significant reorientation are less precise in the nature of the objectives developed. The major points for each division are summarized below.

Office of the Administrator

The Office of the Administrators planning is oriented toward establishing the necessary structure and operating characteristics resulting from the agency's more independent status. The Administrator is perceived as functioning in primarily a policy coordinating capacity with the ongoing operational responsibilities delegated to the Deputy Administrator for Program Operations. One of the aspects of this process is the consolidation of administrative and management functions within the Office of the Administrator. The Professional Review Committee, an ongoing process of program review for purposes of policy evaluation is planned under the direction of the Deputy Administrator for Policy and Program Review. This componant of the Administrators Office is envisioned as functioning in the manner of a counsel to the Administrator, providing a liason woth program divisions and a conduit of information for purposes of policy development.

Office of Regulations and Interpretations

ORI does not plan undertaking any additional functions or significant organizational changes. The primary emphasis in operating objectives is to improve productivity, reduce processing times and increase the level of activity within current programs. The reduction of backlogs and development of a regulatory agenda consistent with the Administrator's policy are major considerations. The need to hire and train additional staff over the next several years is foreseen, in conjunction with training initiatives to improve and update competencies.

Office of Program Services

A restructuring of OPS is anticipated in order to place the functions of the Management Support Group under the direction of the Administrator's Office. As a result, plans for the anticipated Administration and Management Group are presented separately. Several program reviews and management evaluations are planned to review current and projected requirements in the other functions of the office. These afford the potential for further reorientation in the types of functions performed and a redirection of emphasis. Operating objectives are primarily concerned with maintaining the ability to meet workload demands in current functions which are anticipated to steadily increase. This is of particular importance in the statutorily required public disclosure activities. The need for office automation, some additional staff and training programs is projected in order to accomplish this.

Office of Enforcement

Reorganization of both the National Office and field structure is planned for the upcoming year. This will result in a consolidated field structure with fewer offices and a National Office organized around three groups of functions, National Investigations and Review of the Field, Field Coordination; and Technical Support. The development of a National Investigations unit and acquisition of line authority over the field are new functions in the enforcement area.

In addition to structural changes, a broad range of initiatives are planned. These include development of a policy review mechanism, review and development of auditing and enforcement methodologies, annual revision of compliance strategy documents, improvement of interagency coordination and automation of field offices. A comprehensive training program is envisioned to update investigators' skills over the next several years to complement the increased availability of technical assistance provided by the new unit.

The Office of Enforcement anticipates the need for a significant increase in staff in order to accomplish these objectives.

Office of Research

Coming off a period of minimal funding, the research program anticipates a number of projects over the next several years. Due to the nature of the activity, the planning is presently solely as a delineation of projected topics. Over the next several years, data derived from the Form 5500 filings will be developed into a historical longitudinal database for use in regulatory and enforcement programs as well as for research. Statistical analyses and aggregations will be compiled from this. Studies on rates of return of plan assets, benefit levels and legislative-regulatory impact are also planned for 1985. In FY 1986 it is anticipated that significantly greater funding will be available. Analysis of plan financial structure, enhancement of the 5500 database and an international comparative study are projected.

Office of Information Management

The planning is focused on the requirements of bringing a new organizational unit to fully functional status while coordinating the office automation and electronic filing initiatives. Unlike other offices within OPWBP, OIM is an entirely new entity derived from the division of the prior IMSA structure. This requires that the initial efforts be directed toward the training of staff for new roles and establishment of systems to ensure the timely processing of required data and reports.

Concurrent with efforts to establish an ongoing program, OIM also will coordinate the development and acquisition of the electronic filing system and associated office automation equipment. A pilot program will be conducted in FY 1985 during which developmental work under contract with MITRE will be monitored. In FY 1986 the hardware procurement is anticipated to begin, with software development and initial operation planned for the following year. The entire project is projected to become fully operational by 1988.

Consistent with this dual role, OIM's plan contains two components. The first addresses ongoing operational issues and the second the sequence of events and projected costs associated with electronic filing.

U.S. Department of Labor
Office of Pension and Welfare Benefit Programs
Washington, D.C. 20210

MEMORANDUM FOR: ALAN D. LEBOWITZ
Deputy Administrator for Program Operations

FROM: ROBERT A.G. MONKS Robert A.G. Monks
Administrator

SUBJECT: Planning for the Future of OPWBP

In my efforts to provide leadership to the ERISA program within the Department of Labor, I have been working within the parameters of (i) my own agenda and (ii) externally imposed constraints. Planning is a difficult process for a newcomer to government because of a lack of understanding of the limits of practicality. Following the advice of Peter Drucker, I will spell out what I feel to be the ideal plan for the ERISA program and then will make such compromises as appear to be necessary.

I will divide the "plan" into five parts: (I) An enumeration of the duties of DOL under ERISA and Reorganization Plan No. 4 of 1978; (II) An expression of the explicit assumptions that underlie the recommendations in the Plan; (III) A cataloguing of the underlying characteristics - or modalities- ideally present in a fully successful program; (IV) A summary of what is needed conceptually in terms of personnel, material and organization in order to achieve the desired level; and (V) A conclusion that lists and describes the primary functions of OPWBP and an allocation of responsibilities for preparing detailed operating plans with respect to their functions by 15 October.

I. DUTIES

The Pension and Welfare Benefits Office ("PWBP") carries out the responsibilities of the Department of Labor ("DOL") under ERISA. As enacted, DOL's administrative, enforcement and regulatory responsibilities under ERISA were spelled out in Title I. Following Reorganization Plan No. 4 of 1978, DOL assumed authority from the IRS for interpretation, exemptions, regulations, etc. in the prohibited transactions and fiduciary standards area while giving up such authority to IRS in connection with certain provisions contained in parts 2 and 3 of Title I.[1]

These responsibilities can be divided into four major categories:

1. The filing of annual reports by plans. At a minimum, it is OPWBP's responsibility to prescribe the form and substance of the information required to be filed with DOL by employee benefit plans. Given the legal obligation of plans to file this information, it is our obligation to assure that it is received and processed efficiently and made available for utilization for numerous governmental and several public purposes that depend on its availability. With a computer system and filing information in digitalized form, very current and comprehensive information can be available for research policy and enforcement purposes. These requirements for filing include not only Forms 5500 but Summary Plan Descriptions ("SPD") and other documents.

2. Fiduciary Duties and Prohibited Transactions. The most important substantive rulemaking responsibility OPWBP has is in the fiduciary standards and prohibited transactions area. In this regard, our principal vehicle for establishing the standards that constitute acceptable conduct by fiduciaries under ERISA is the individual and class exemption process. The promulgation of generally applicable interpretative regulations and the issuance of specific advisory opinions is another aspect of this responsibility to set the rules and provide guidance to the public.

3. PWBP is responsible for assuring compliance with the provisions of Title I of ERISA. To accomplish this task, it is granted rather extraordinary investigative powers and the right to be involved in ERISA related litigation. It, therefore, has the responsibility to determine the jurisprudence of ERISA and to assure a level of enforcement that encourages voluntary compliance and suggests unacceptable risk to the non-complier. With respect to enforcement for ERISA's reporting and disclosure rules, it should be possible to verify whether annual reports are being timely filed by cross checking with the IRS and identity of taxpayers who are claiming deductions for employee benefit programs.

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[1] The final allocation of tasks between the IRS and DOL, Reorganization No. 4, 1978, might be held to be unconstitutional, due to the Supreme Court's holding with respect to "legislative vetoes." This plan is based on the assumption that the issue never arises and that the present allocation remains intact.

4. "The Secretary is authorized and directed to undertake research studies relating to pension plans..." §§513 a)(2). There is some indication that the Secretary is expected to use the enormous body of information for which he is custodian to provide leadership to the executive branch of government with respect to pension policy, or at least the voluntary privately sponsored component thereof.

5. Although not mandated by the statute, a substantial (and continually growing) number of plan participants look to PWBP for answers to their questions about their rights under ERISA and for help in resolving disputes regarding benefit entitlements. It is quite clear from the number of congressional inquiries we receive that Congress and the public expect OPWBP to provide this service. This element of OPWBP's program is important not only for what it does, but because it is the one circumstance that brings the government agency that is responsible for protecting participants rights in contact with individual plan participants.

II. ASSUMPTIONS

1. Frankly, the last ten years would suggest that there is general public acceptance for a "low level" of operating competency with respect to the ERISA program within DOL. There has been no sense of outrage in the public, and the Congress' concerns have been primarily focused on the Department's ability to respond to applications for exemption from the prohibited transactions rules, and enforcement efforts in so far as they relate to organized crime. [The creation of the special unit within the Inspector General's office for investigating organized crime and the hearings of the Nunn Committee are evidence of this.] This plan is premised on the existence of support (i) within the executive branch (DOL policy and OMB), (ii) the Congress, and (iii) the public for an efficient and fully-functioning Pension Office. This assumes, inter alia, a willingness on behalf of the executive branch to make, in the case of PWBP, the commitment and leadership of appropriate Congressional leaders and committees; and effective mobilization of the opinion of plan sponsors that professionalism and efficiency in the federal government's pension oversight agency is the preferable policy.

2. Because the Department has organized the National Pension Forum to provide an instrumentality for the expression of opinions respecting the optimum organization of DOL's responsibilities under Title I, it is premature at this time to propose a definitive plan. Such will have to await the outcome of the

Forum and the acceptance of its recommendations by the Secretary and the Congress. Thus, this plan will be crafted on the assumptions (i) that it will not be incompatible with the results of the Forum and (ii) that Forum recommendations can, in the future, be added to those contained herein without violating the spirit of either.

III. MODALITIES

For purposes of planning, I have identified certain characteristics or attributes that the Labor Department's pension agency should possess. These "modalities" suggest certain organizational conclusions, which will be discussed in the next section.

1. Professionalism

The ERISA statute is highly technical and has an impact on a sophisticated industry. Indeed, there are few areas in the private sector where legal, accounting, actuarial, investment banking and other highly skilled professions are more involved than in matters relating to ERISA. As the assets subject to ERISA, estimated to increase from today's $1000 billion to $3000 billion within ten years, become an increasingly dominant factor in capital markets, only minor and exceptional financial or social needs will be able to be met without reference to the impact of ERISA. What this means is that ERISA funds will become such a large portion of the total assets that access to them becomes a litteral necessity for projects of any magnitude. ERISA has incorporated the common law prohibitions against self-dealing and interested party transactions. These doctrines can easily be understood and applied when the relevant assets are exceptional and small with reference to the economy as a whole. ERISA assets now threaten to become a substantial part of total investment assets. The nature of ERISA involves a requirement that DOL investigate particular transactions in order to determine whether exemption from the "party in interest" rules is appropriate. The Congress specifically repudiated in conference the House version of the bill that would have used a test of "arms length" as legitimizing a transaction between parties in interest. It is, thus, indisputable that the Department is expected to consider individual exemptions. These will become more numerous and more intricate as the need for use of ERISA money is increasingly viewed as indispensable.

The impact of ERISA is felt particularly acutely in the investment banking field, that area that needs and claims the highest level of professionalism in the private sector. In as much as the law unequivocally requires DOL involvement in the exemption process for individual transaction, a large highly professional staff will be necessary. Beyond this, substantial continuing attention will need to be devoted to assuring that the agency be sensitive to "class exemptions" so as to permit the flow of commerce to be as little impeded as possible. In addition, a high level competency to review and formulate a strategy for developing an ERISA jurisprudence is desirable. This would involve consideration of the whole panolply of regulatory / investigative / litigative alternatives and the development of priorities and an articulated policy.

2. Continuity

While accountability to elected officials is essential to the legitimacy of any agency, there is an underlying and not incompatible need for continuity. This is particularly apparent in the case of an agency such as OPWBP having the responsibility for administering a technical statute whose application to a dynamic economy requires constant attention and change. The public must be able to have confidence that agencies such as OPWBP will apply comprehensible standards to the application of the law. In other words, the circumstances will always be in a state of change, but there must be confidence that the underlying philosophies, the commitment to quality, for example, will have elements of continuity. The development of a law such as ERISA is an on going process. The rule making process under the Administrative Procedure Act requires months, and years may well pass between the conception of the idea and its final status. With litigation, decision to bring a case may well precede by a decade its final adjudication. Commitment to a continuous and comprehensible policy is the only alternative to anarchy. Political administrations will come and go during the full life cycle of a complicated regulation or a routine litigation. There must not be any question as to the agency's commitment to carry through in matters requiring sustained effort over many years. Thus, the agency should have elements of continuity in its organizational structure both at the policy and at the administrative levels. There has to be a practical capacity for an institutional memory to develop. The agency cannot constantly be redirected to new priorities at the expense of following through with outstanding matters. Its organizational character should permit the tension of new and old to coexist - there should be capacity to accommodate the new political mandate without at the same time requiring the abandonment of ongoing commitments.

3. Non-partisan

It is clear that political leadership is essential. There must be someone to make decisions, there must be someone who is capable of being wrong. The career civil servants have the obligation of assuring the high quality of the work and informing the political leaders of the options that are available, but the decisions must be attributed to the political appointees. However, political decision making is not the same thing as partisanship.

I have noticed with some discomfort that PWBP is considered in a partisan way. In the event of a Democratic president, organized labor views itself as entitled to particular consideration. Republicans are thought to focus enforcement efforts preponderantly in the direction of Labor Unions. The perception of partisanship - whether true or not - is harmful to the ERISA program. Employee benefit plan policy relates to administering laws providing retirement and other employee benefits. It should not be a partisan matter. As a practical matter, some elements of partisanmanship are inescapable. Indeed, it is naive to think that accountability to the electorate is possible without attention being paid to election results. What is needed is an institution that is capable of reflecting a legitimate partisan concern without dominating the agency's long term agenda. The evolution of an ERISA jurisprudence will take time and continuing attention. Rapid changes due to partisan considerations can not be allowed to dominate the focus and functioning of the agency.

4. Access to Public

ERISA is complicated, it affects many people. It will broaden in years to come although even today its impact is felt by 50-60 million people. No one who has been involved with ERISA in a detailed way would opine seriously that the law is simple. The fact is that people need help in complying with the law and in understanding what are their obligations and entitlements thereunder. Pension administration should not be confrontatory, except in cases of abuse. The focus should be primarily on reaching out to people, to perform preventive maintenance,so to speak, rather than in relying principally on enforcement.

5. Scope

The questions of organizing retirement income responsibilities within the executive branch have been considered at length. The conclusion has been that they should be discharged by many different agencies. Focusing simply on the three agencies charged with responsibility under ERISA, it does not seem sensible to raise again issues that Congress has dealt with as recently as ten years ago. The terminology "single agency" has come to mean amalgamation of all ERISA responsibilities in a single entity. This plan does not contemplate a single agency. It does focus on the need to have some where in the executive branch an agency responsible for formulating retirement income policy in the broadest terms - not limited to the revenue raising priority of the IRS or the insurance concerns of the PBGC, for example.

§§ 513 (a)(2) provides "The Secretary is authorized and directed [emphasis added] to undertake research studies relating to pension plans, including but not limited to (A) the effects of this title upon the provisions and costs of pension plans, (B) the role of private pensions in meeting the economic security needs of the Nation, and (C) the operation of private pension plans including types and levels of benefits, degree of reciprocity or portability, and financial and actuarial characteristics and practices, and methods of encouraging the growth of the private pension system." The annual reports of plan sponsors are required to be filed with the Labor Department, thus making available the most current information about the status of the pension industry. It would appear as if the Department had the information base and the statutory responsibility to report on the health and needs ~~of the~~ national "retirement income system" and otherwise broadly as to the impact of ERISA.

IV. NEEDS

1. It is essential to agree on the functions and on the level of performance desired for PWBP. It is at least clear that the present level of functioning has not elicited strenuous objections from the various private and Congressional constituencies. Does this represent a mandate for continuing the status quo? If it works, don't fix it? While individual practitioners have been vocal about the delays involved in regulations and exemptions, and while Congressional committees have focused on the inadequacy of the enforcement effort, there is no perceptible surge of opinion demanding quick and violent change, and very little demanding any kind of change, at all.

For planning purposes, it is assumed that the objective is to achieve a level of professionalism comparable to that of the IRS and the SEC - that the agency will be able to turn out a professional product on a schedule that accommodates the reasonable needs of commerce. It is further assumed that DOL and OMB are sufficiently persuaded of the priority needs for a fully functional PWBP that its personnel and budget requests can be accommodated within departmental or administration limits, notwithstanding any general directives for reductions. In other words, this plan assumes that the decision has been made to provide the resources necessary for PWBP to discharge the functions as characterized in III, above.

2. Organizational Structure

The National Pension Forum was convened by the Secretary in order to consider all relevant evidence from within and outside the Department as would enable it to make recommendations as to the organizational structure that DOL should adopt in order to discharge its obligations under Title I of ERISA. The Forum's recommendations are not due until Mid-November 1984. For planning purposes, it will be assumed that whatever exact form of organization is recommended by the Forum that its personnel, equipment and money requirements will not differ substantially from what is recommended herein. In other words, the Forum may recommend the creation of a new Commission or it may suggest a new structure within DOL paralleling that of PBGC. In either event, the functions to be performed and the resources necessary to their achievement would not be materially different. This plan focuses therefore on what is to be done and the level of quality of execution. To the extent that any organizational assumptions are being made, they are that PWBP is elevated to the level of an agency under an Assistant Secretary.

3. Personnel

With the recognition of PWBP as a professional organization with the highest standards, there will need be a focus on training all levels of personnel. Following the development of appropriate programs, all employees will be given the opportunity to bring their skills to the levels required. Every effort will be made to find employment for existing personnel, but the new requirements inevitably will be difficult for some to satisfy. The pension area is so dynamic that planning includes provision for a permanent training facility. For the foreseeable future, key personnel will need to be carefully recruited. It is assumed that PWBP will add 25 persons immediately with another 50 over the next nine months. Thereafter, assumptions are difficult as much depends on the Forum's recommendations and their reception. For planning purposes, it will be assumed that PWBP will have the number of people needed for a fully functional program starting on October 1, 1985.

4. Equipment

The basis of the commitment of PWBP to professionalism is the most rapid installation possible of an adequate information process system. This will require the acquisition of hardware, software and access equipment both in the national office and in the field. Also, substantial work will need be done in order to obtain access to historical data now existing in digital form. Possibly, additional key punching will be needed in order to make the historical material complete and useful for comparison purposes.

5. Conclusion

Each of the indicated persons for the respective offices within PWBP as set forth below should develop detailed plans of their personnel and equipment needs over the next five years. Clearly plans depend on what is the program. As a first step it will be necessary to define exactly what tasks each office is going to undertake within the relevant time spans.

Preliminary component draft plans will be due on 15 October with a comprehensive PWBP agency plan to coincide with the Forum's final report to the Secretary on 15 November. I would like you to be responsible for the plan; Richard Hinz is assigned to you to expedite preparation.

For purposes of preparing this plan, it can be assumed that 25 additional personnel slots will be available before November 15, 1984, in accordance with our request to the budget office, and that we will be able to have an additional 50 positions during fiscal '85 in accordance with the Secretary's approval of the budget for '86. It should be assumed that we will be able to get justifiable increases in personnel for fiscal '86 and that in the interim such funds as we need can be made available. The references herein to particular offices do not coincide with existing structure; the nomenclature is descriptive and not necessarily permanent; the office names and the underlying descriptive material are intended to describe functions.

1. Office of the Administrator

The office of the Administrator needs to be organized and staffed as the on-going executive for PWBP. Detailed planning will not be possible until the exact organizational structure is clear. It will make a difference, for example, whether the model of the SEC is followed or whether a traditional vertical management scheme is adopted. All this depends on the Forum's recommendations and the Department's actions to implement such recommendations.

2. Administrative, Budget and Planning Operations / David Ganz

The operations component is responsible for all operating functions, preeminent among these is working with and coordinating with OASAM. It is important to develop a sense of those duties best discharged by OASAM and those that we need to be able to do for ourselves. Among the areas in which it is clear to me that we need in-house competency are planning and budget. The pension office will always have to be responsible for communicating its own perception of its needs. We will need a personnel competency. Under the present arrangement, for example, we have to be able to get access to the SOL's Schedule A hiring authority. We need to upgrade the Agency's professionalism. This will require an in-house training competency on an on-going basis.

3. Information Handling / Merv Schwedt

The five year plan that has been prepared for the budget office probably reflects most of the implicit assumptions that should be made explicit for the purpose of this plan. By this I mean simply that personnel and equipment needs appear to have been thought through in the contest of the missions expected to be performed. This office becomes the operating heart of the agency with its implications in the area of public disclosure, enforcement and policy and research. In addition, of course, the intra-office communications systems are essential to the other offices.

4. Pension Statistics and Research / Dick Ippolito

I contemplate a substantially larger research capability in order to accommodate the availability of data through the Office of Information Handling and to be responsible as *the* Executive branch source of information and analysis necessary for prompt and correct policy making.

5. Office of Enforcement / Chuck Lerner / (Assisted by Sue Ugelow)

The Enforcement Task Force has produced an excellent analysis of what is needed. The plan should elicit an answer as to how, when, and with whom implementation can be expected. Decisions will have to be made as to how to organize the national office, how the field is to be supervised, how the field is to be configured and staffed, the relationships with the solicitor's office, and national office investigative capability.

6. Legal Policy and Jurisprudence / Mort Klevan

Those involved with the development of legal policy will be responsible for the jurisprudence of the agency. Policy must be coordinated as to regulatory, investigative and litigative activities so as to accord the priorities. The purpose of this activity is to permit the agency in some regard to set its own priorities and not simply acquiesce in responding to external crises. A separate consideration is being undertaken in order to provide coordination for the activities of the other offices. This activity would, for example, consider whether time is more usefully employed in developing class exemptions in a particular area or in continuing to consider applications on an *ad hoc* basis.

7. Regulatory Activities / Elliot Daniel

This office (ORI) is responsible for processing all kinds of applications in a professional and timely manner. It ought to be able to function with a schedule of the time needed to handle particular kinds of matters. The public ought to be able to enter into transactions without having to disregard those that require procession by our Agency. This will be a question of organization, hiring and training and leadership.

8. Public Assistance and Services / June Patron

ERISA is a complicated statute involving many people. A central part of our operations should follow the modality of "preventative maintenance." There ought to be an outreach to help. Substantial of the operations of this office are susceptible of being dramatically improved by modernization of information handling, as described previously. However, planning will have to be based on current processes for information handling, but be flexible enough to accommodate changes. Particular emphasis will have to be given to defining specific programatic objectives and procedures for each division within OPS, an identification of staffing deficiencies and excesses and a detailed proposal for dealing with identified imbalances. Specific proposals should be developed for training and development of operational procedures.

U.S. Department of Labor

Office of Pension and Welfare Benefit Programs
Washington, D.C.

MEMORANDUM FOR: OPWBP EXECUTIVE STAFF

FROM: ALAN D. LEBOWITZ
Deputy Administrator for
Program Operations

SUBJECT: Long Term Planning

In order to facilitate the process of developing a comprehensive long term plan the following set of guidelines has been developed. These should be of assistance in providing a format and conceptual framework as you begin to formulate plans. The guidelines are general and somewhat abstract in order to be applicable to the diverse nature of the various programs. Discretion and creativity should, therefore, be exercised in adapting them to the particular requirements or circumstance relevant to each program area.

Planning Model

The process of strategic planning is essentially focused on making determinations of what the agency is currently doing, what it should be doing, and the difference between the two. This should lead to the identification of a set of steps or initiatives designed to reconcile current operations with those of an ideal or fully functional agency.

The term or timeframe of the plan is a major factor in this process. OPWBP currently is faced with three planning horizons. Planning is required for activities which will be conducted in the short term (the present through the end of FY 1985), the intermediate term (through the end of FY 1986), and the long term (the next 5 or 6 years). Each of these periods is associated with a set of resources (budgetary) and constraints (time, personnel, etc.) which should dictate the parameters within which plans are formulated. In the broadest sense, the planning exercise may be viewed as a series of decisions concerning what the agency seeks to accomplish within each of the three timeframes and the prioritization of steps necessary to achieve this.

Decisions of this nature will necessitate analysis of program direction and activities. Of particular importance to this analysis are the concepts of goals and objectives which are the foundation for operational decisions. Goals may be defined as the purpose of mission toward which a function or initiative is directed. Goals may be of a general nature such as "modalities" which are set forth in the Administrator's memo. These are directed to OPWBP as a whole, with all of the offices expected to direct planning toward the abstract concepts of professionalism, non-partisanship, etc. Goals may also be program specific. Protection of beneficiaries for example is a goal. Each part of OPWBP is directed, or ideally should be directed toward both specific goals related to the function as well as the broader goals of the agency. These will need to be set forth and articulated as a basis for the planning process.

Objectives are specific milestones or measurable accomplishments which indicate progress toward a goal. If the goal is protection of beneficiaries, an objective related to this goal may be the implementation of a benefit disputes system, or it may be more specific such as processing a given number of disputes. Each functional activity should, thus, incorporate both goals and related objectives which state what is intended to do and how it will accomplish this. These are the starting point for an analysis of activities and formulation of plans. The development of a set of goals and objectives will result in the definition of a strategy.

With these concepts in mind a model of the planning process may be formulated. It is in its simplest form an input-output model. A set of inputs (the current program structure, its related goals and objectives, policy decisions, the Administrator's "modalities", available resources, legislative provisions) combines with external factors; in this instance OPWBP operating environment and plan universe. This results in the sequential outputs of new goals and objectives which lead to specific operating plans. This may be shown schematically as:

inputs	outputs	
current program		
ideal program	redefinition of goals and objectives	operating plans
constraints		

The importance of this model is that it implies a comprehensive and integrated process in which activities are derived from a clearly articulated set of priorities which are reconciled with the limitations of time, resources or other factors.

Format

Based on this theoretical approach a two part format for the presentation of long term plans is proposed. The first part would involve the analysis of current activities and strategy. This would be followed by the definition of a fully functional program incorporating current policy and desired modalities. This would lead to the definition of goals and setting of objectives which answer the questions; (1) what are we doing now, and (2) what do we want to have done through each of the three planning horizons? Defining goals and objectives will require the articulation of the rationale behind them providing a comprehensive statement of the organization's policy direction.

The second part of the format involves the translation of objectives into specific operating plans. Once it has been established where we are and where we want to get to, this part will address the issue of how to get from here to there. This is a process of delineating the steps required to meet the objectives which have been set forth.

A general format for the initial part of the planning process, definition of goals and setting of objectives is outlined below. In some cases this may be adaptable to an entire functional area. The more complex program areas however may need to be divided into several sub-functions each of which is addressed using the format.

I. Definition of current functions. This should define the current activities leading to an analysis of the goals, objectives and constraints on which they are based. Topics which should be addressed include:

   1. Description of current activity structure, the major function which the office is now performing.

   2. Discussion of the general goals toward which these are directed, what assumptions are implicit in this program structure.

   3. Discussion of specific operating objectives, how do these relate to the goals, what criteria are used to evaluate progress toward these objectives.

4. Discussion of the operating environment. What internal and external constraints are factors in determining this program and activity structure.

II. Definition of an ideal or fully functional program

This section should define the ultimate goal over the term of the plan and provide an analysis of how this differs from current operations. Topics which should be addressed include:

1. What are the goals toward which a fully functional program should be directed?
2. Do these include operating goals as well as general goals, (the Administrator's modalities)?
3. How do future goals differ from current goals?
4. What assumptions about the operating environment are implicit in establishing these goals? What factors contribute to constraints limiting the ability to achieve them?
5. What is the rationale for any additional or altered goals?
6. In general, what are the implications of these goals to the activities; do they require the expansion of current activities or additional program elements?

III. Setting of Objectives.

This section should establish a set of specific objectives designed to direct program operations toward the goals outlined in the previous section. A set of objectives for each of the three planning periods should be presented. The discussion of each of these should include:

1. Delineation of the objectives.
2. Discussion of the rationale, how it relates to the goals.
3. What measurable criteria will indicate achievement of the objective?
4. Are objectives consistent with the current activity structure and constraints?

5. How are they related to assumptions concerning the internal and external operating environment?

6. What changes in activities do the objectives imply?

The next step in the planning process is the development of an operating program which translates the objectives which have been developed into specific steps designed to achieve them and establishing a schedule for this to occur.

This operating plan should be presented in a structure based on the three time periods. Within each of the time periods, objectives should be organized into three categories; (1) related to current or on-going functions, (2) related to the improvement of current functions, (3) related to new or expanded functions. Discussion of objectives related to current functions is of greatest significance for the FY 1985, with the implicit assumption that this "baseline" level of function will remain throughout subsequent years and will not require a repetitive presentation. The later time periods should be focused on initiatives for the improvement of current functions or additional activities to be undertaken.

For each objective presented, a series of steps, or program for its achievement should be presented with a preliminary schedule for the completion of significant milestones. Any assumptions relating to the ability to achieve the objective should also be articulated, such as the hiring of personnel or availability of funding. This is of particular significance in the out year objectives for which no clear determination of available resources can currently be made.

Objectives should be written in a manner which establishes some measurable criteria to evaluate the degree that they are achieved. In some instances this may be a reduction in processing times or the completion of a specified number of workload units. Other area may require that objectives be stated in procedural terms, which set forth a desired process for areas which are unpredictable or for which quantitative measures are not applicable. An abbreviated example of an objective based program is shown below:

FY 1985

I. Current Function
   A. Objective - processing of 50,000 units of XYZ requests during FY 1985.
   B. Assumes the current level of demand for the service and current staffing level for the XYZ division.

C. No change in current operations.

II. Improvement of Current Function
  A. Objective - to increase the level of professionalism within the XYZ division.
  B. Assumes the availability of $10,000 of training funds.
  C. Program -
    1. Identification of staff deficiencies 1/85 to 2/85
    2. Development of training program 2/85 to 3/85
    3. Completion of training for ten professional staff 6/85

III. Additional or Enhanced Function
  A. Objective - to develop the capacity to process ABC requests.
  B. Assumes hiring of personnel included in FY 1985 budget - 2 GS-09 ABC Examiners.
  C. Program -
    1. Hiring of personnel 2/85
    2. Training of personnel 2/85
    3. Processing 25 ABC requests per month by 6/85.

U.S. Department of Labor

Office of the Assistant Secretary
for Administration and Management
Washington, D.C. 20210

Reply to the Attention of:

DEC 31 1984

MEMORANDUM FOR: ROBERT A.G. MONKS

FROM: FRANK A. YEAGER
Director
Directorate of Personnel Management

SUBJECT: Review of OPWBP

I have completed a review of OPWBP's mission and program goals, organization and staffing structure, and staff qualifications. This memo provides recommendations, which you requested, on actions which should be taken to help accomplish your goal of making OPWBP the "best professional organization in the Department of Labor".

In reaching these recommendations, I:

-- reviewed the OPWBP mission and function statement, the position descriptions of all SES and most National Office senior merit pay staff, and the performance standards for these same individuals.

-- reviewed recent reports on the OPWBP program; including those of the Enforcement Working Group, the Walsh Committee, the LMSA/OASAM Study Group, the OASAM/DIT review of ADP, and GAO and OIG audit reports.

-- interviewed 60+ persons, primarily in OPWBP. These interviews included most National Office staff at the Division Chief and above level; a group of Local 12 Officials representing bargaining unit staff; members of the Denver, Boston, and Chicago area offices, and the field members of the Transition Committee.

-- reviewed material prepared for the FY'86 budget request to the Department.

-- reviewed the Report of the OPWBP Transition Committee.

-- reviewed the draft of long term plans submitted in response to Alan Lebowitz's September 7, 1984 request.

The primary purpose of this review was to develop recommendations for those actions which should be initiated now if the opportunity to set a new direction for OPWBP, presented by the recent reorganization, is to be seized.

Recommendations are in three broad areas:

-- Personnel management; including staffing, training and staff development, position design, and performance management.

-- Organizational arrangements in both the National Office and the Field.

-- Administrative arrangements essential to the creation of a management system structure for OPWBP.

The high caliber and dedication of the OPWBP staff is impressive. This staff is clearly interested and motivated toward your goal of excellence and professionalism. This, plus the fact of the reorganization, provides a unique opportunity to significantly determine the future direction of OPWBP. I appreciate the opportunity to provide my recommendations at this time.

Finally, I wish to thank everyone I had an opportunity to meet with in OPWBP in connection with this review. Without exception, each was positive, concerned, and forthright. It has been a pleasure.

.. PERSONNEL MANAGEMENT

A planned and continuing program to recruit and train talented individuals in well-defined positions is the most important action which can be taken for the growth of OPWBP into a significant Government institution.

Such a program must be designed in recognition of two important external conditions.

-- Government employment, per se, is no longer attractive to many highly talented individuals. Anti-Government and anti-Federal employee campaigns over the past ten years have greatly diminished the public service attraction which was so valuable to past recruitment of entrance level talent.

-- The career service as we have known it in the past can no longer be assumed. Changes made and changes to be made in the civil service retirement system will almost certainly enable individuals to more easily move between the Federal and private sectors. A staffing consequence will be that talented staff which have obtained marketable skills in the Federal service will be more willing and able to move to a private employer. Further, a Federal agency will be less competitive in the recruitment of talent at the mid-level.

Beyond these general conditions, OPWBP's size limits the organization's ability to conduct an effective staffing program to a very few occupations--preferably one, but two or three at the most.

-- OPWBP does not have the resources to provide, for a variety of occupations, the quality of training essential to attract and retain quality staff.

-- Advancement opportunities must be as broad as possible both to retain top people and to make maximum use of available talent. Career fields viewed as second class in terms of potential advancement within the organization and/or training and career growth opportunities will neither attract nor retain top quality people.

-- Newly hired people should bring as much training as possible to the job. Fully qualified people should be hired for few-of-a-kind positions. For the major occupation(s) in the organization, limited resources should be used to train in ERISA, not to provide training in skills and knowledges readily obtained in schools.

A. Staffing in the Field

In this context, the following staffing recommendations are made.

In the Field organization:

-- HIRE ENFORCEMENT STAFF AT THE GS-5 AND GS-7 LEVELS.

-- USE THE INVESTIGATOR EXAMINATION FOR APPOINTMENT WITH THE ADDITION OF SPECIAL QUALIFICATION REQUIREMENTS.

-- CONDUCT HIRING ON A CLASS OR BATCH BASIS RATHER THAN AS VACANCIES OCCUR.

-- DESIGN AND PROVIDE A SYSTEMATIC TRAINING PROGRAM FOR NEWLY HIRED FIELD STAFF.

1. Hiring at GS-5 and GS-7

Hiring at the GS-5 and GS-7 levels provides the following advantages:

-- It offers the best opportunity to secure talented individuals who will remain with the organization for sufficient time to repay the training investment.

-- The training task is simplified, as a single program can be designed for all new hires.

-- A far higher percentage of new hires will enter service with a probationary period requirement.

2. Using the Investigator Examination

Previous reports, confirmed in interviews, indicate that with few exceptions there are no significant differences in the types of assignments given auditors and investigators. This fact should be recognized and a single job classification of investigator, GS 1801, used. Recruitment will be more efficient. Training costs will be decreased. Performance management will become simpler. And it will be easier to develop a common professional orientation as professional rivalries which develop for the limited number of supervisory positions are removed.

The investigator examination is announced by OPM when an agency requests candidates. This will offer OPWBP an excellent opportunity to recruit for the examination and thus directly influence the quality of the persons certified.

The nature of the work of the OPWBP investigator requires that special additional qualifications be possessed by new staff. Selective certification requirements should be developed in cooperation with DPM and their use mandated for all field recruitment. These requirements should provide that selections be limited to persons with 15 to 18 college credit hours of accounting course work or equivalent experience. To the extent that candidates for employment have demonstrated accounting skills, training costs will be reduced as it will not be necessary to provide basic accounting training. Further, the training which is provided can be designed assuming a common understanding of accounting. Beyond accounting knowledge, preference can be given to persons with education and/or experience in such fields as real estate, banking, stock brokerage, etc.

3. Class Hiring

Class hiring is important for a number of reasons.

- -- First, it is essential to effective and efficient training of new staff. Organized class training shortly after entrance on duty is critical. A class hiring approach is the only way an organization the size of OPWBP can be assured of a class size group of trainees shortly after each enters on duty.
- -- Second, class hiring can result in a higher utilization rate of available FTE if hiring is properly scheduled.
- -- Third, a more effective recruitment program can be conducted.
- -- Finally, staff reallocation can be accomplished on a planned basis by moving vacancies rather than people, thereby reducing the personal and organization costs of geographic staff moves.

4. TRAINING NEWLY HIRED STAFF

The nature of the field job requires that training be given before investigation assignments are performed for the following reasons:

- -- Staff are generally assigned to work individually.
- -- Assignments are performed outside of the office which means that many decisions cannot be subjected to detailed supervisory review.

-- The nature of work assignments generally requires field staff to be able to recognize a wide range of potential problems in any investigation.

Classroom training is the only efficient and effective method to provide the necessary pre-assignment training. OJT is far too expensive and lacking in uniformity of both quality and content.

INITIATING ACTIONS TO IMPLEMENT STAFFING RECOMMENDATIONS FOR FIELD STAFF

1.a. Request DPM to develop a statement of special qualifications for the investigation examination and issue this statement to the Regional Personnel Officers with instructions for its use.

b. Send a copy of the DPM developed material to Area Directors with appropriate management direction.

2. Request DPM and the Office of the Comptroller to develop a methodology for projecting investigator vacancies and procedure for instituting a class hiring system.

3.a. Establish an OPWBP management group, consisting of the Deputy Administrator for Program Operations and the Assistant Administrators for Enforcement and for Regulations and Interpretations, to direct development of a training course for new EO/ORI staff.

b. This group should approve a statement of learning objectives which must be accomplished by new investigator staff before conducting an investigation.

c. Request DPM to assist in identifying a contractor who will develop a course, working with OPWBP staff, to provide training in the learning objectives.

B. Staffing in the Office of Regulations and Interpretations

Staffing recommendations in the Office of Regulations and Interpretations include:

-- A DETERMINATION BE MADE OF THE SPECIFIC POSITIONS WHICH MUST BE STAFFED WITH LAWYERS IN ORDER THAT ORI STAFFING PROBLEMS CAN BE ADDRESSED.

-- DESIGN AND IMPLEMENT A TRAINING PROGRAM FOR NEW PROFESSIONAL STAFF IN ORI.

One of the major National Office staffing concerns is to find a method to more quickly and easily appoint high quality persons with legal training in the Office of Regulations and Interpretations. Discussions have been held with Solicitor Lilly regarding the use of Schedule A appointment authority for selected positions in ORI. He expressed a willingness to consider this problem in terms of specific positions.

What needs to be determined are the specific positions which require legal training, and how the responsibilities of these positions relate to the responsibilities of the Office of the Solicitor. If there is duplication with the SOL, the problem becomes an organizational one and must be addressed in that context. Any solution of the ORI staffing issue should not result in waste of staff resources through duplication of effort between OPWBP and SOL.

It is also necessary that within ORI the difference in assignment to positions which require legally trained individuals and those which do not be clearly defined. Unless this can be done there is no basis for utilizing two professional occupations in ORI.

Ease of recruitment is not in itself a sufficient reason to appoint under Schedule A authority. Neither is the conviction that better talent can be obtained by use of Schedule A. There must be legitimate attorney positions, the responsibilities of which do not conflict with the Office of the Solicitor, if this problem is one that can be considered solely as a Schedule A staffing matter.

Whatever the final staffing decision, the training needs of ORI staff need to be given equal attention to those of the field staff. The problems differ considerably however. OJT can be effective and efficient in training new ORI staff.

An OJT approach for new ORI staff needs to be carefully designed and monitored. There must be a well designed outline for this training. It cannot be left to individual decisions of the supervisor. As part of this training program, careful consideration should be given to rotating career ladder professional staff into each of the ORI divisions. The key decision required is what kinds of skills and knowledges must be demonstrated and applied by a person before they can be considered to be a full performing professional in the pension program responsibilities of ORI. Once this is established, each person must be systematically provided the needed training, perform the work, and the performance of that work must be carefully evaluated and feedback provided before they are advanced to the full performance level.

I recommend that new ORI staff be included in the basic training course recommended for new field staff.

INITIATING ACTIONS TO IMPLEMENT STAFFING RECOMMENDATIONS FOR ORI STAFF

1. ORI should document the duties performed in professional positions and request the NCSC personnel office to determine if clarification in the legal series is proper. Assuming it is:

   a. An agreement must be reached with the Office of the Solicitor on division of responsibility to avoid duplication.

   b. Request NCSC Personnel Office to establish procedures for rating and certification of attorney candidates.

2.a. ORI should develop a statement of the specific skills and knowledges in which a full performing ORI professional, legal and/or non-legal, must demonstrate successful competence before reaching the journeyperson level.

   b. Identify the formal training, if any, needed prior to assignment of work.

   c. Develop a simple management system which records successful performance of each required skill and knowledge.

   d. Require these requirements be met before promotion to the journeyperson level is made.

C. Career Development

This is the single most important recommendation I can make for increasing professionalism in OPWBP. The decisions made regarding training and career development will largely determine whether OPWBP will reach the sought after status as the leading professional Government organization in the pension arena.

Much has been said and written over the years regarding the need for a greatly improved training effort. The most recent evaluation was offered in the Transition Committee Report. "Perhaps more than any other subject, training has been mishandled ...". This and earlier reports clearly document the need.

Four recommendations are made in the training/career development area:

1. DEVELOP A CAREER DEVELOPMENT PROGRAM FOR CAREER LADDER PROFESSIONAL STAFF OF SUCH QUALITY TO ATTRACT TOP FLIGHT CANDIDATES.

   The OPWBP training program must serve both to attract top talent and equip this staff for their responsibilities.

   As discussed above, the Federal Government has become less competitive for top talent in recent years and this trend is likely to continue. It is now more productive to recruit for a specific job or occupation than for the Government service in general. OPWBP should use as a recruitment strategy an approach that claims and delivers the idea that the training and job experience gained in the organization is the best there is for starting a career in the pension field. People of high ability starting a career will look beyond the immediate job to the value of the training and experience for future opportunities. While such an approach will be expensive in terms of the cost of training and turnover, there is no other approach, short of a draft, that can hope to attract the level of talent desired.

   A well designed training program is also critical to obtaining quality performance consistent with agency policy. Regardless of the talent of the staff, it is not reasonable to expect staff to perform their responsibilities in this very complex program without comprehensive training; nor is it in the best interest of the organization to allow them to do so for the reasons outlined below.

   -- Untrained or partially trained staff cannot be expected to deal effectively with highly trained professionals operating pension programs.

   -- Staff placed in the position of attempting to perform their responsibilities without adequate training are bound to feel inadequate and unprofessional and are very likely to project this impression to the public.

   -- Untrained or inadequately trained staff, in the absence of the organizational direction provided by well designed training, will tend to develop their own criteria for decision making. The organization's policies are then in effect being made by individual staff members rather than by the agency leadership.

-- The introduction of greater technology can only increase the need for training. Technology gives the individual employee greater control than the manager over work.

Career development for pension program professionals must provide a comprehensive program of classroom and OJT from entrance on duty to full journeyperson status. The program must be directly job related, must challenge those being trained, and must present the possibility of failure. No one should be able to assume that mere presence in a training course or on the job will result in retention, let alone progression.

The IRS is often favorably cited for its staff development program. Its training program for new staff in ERISA includes:

-- Phase I: 232 hours of classroom training. This training assumes no knowledge of the law and is designed to provide a basic understanding of the fundamental provisions of the act. This classroom training is followed by closely supervised OJT.

-- Phase II: This is also classroom training which is provided after a year of experience. This is advanced training in greater depth in a number of ERISA provisions.

-- Phase III: Specialized training in areas such as evaluation of assets is given to staff as they start to become more experienced and are assigned more complex work.

Such a training effort will be expensive. That is the reason for recommending fully trained staff be hired for other occupations in OPWBP. However, there are ways to reduce the cost. Contractors can be used to design the course and train the trainers, lowering in-house staff costs for training specialists. It may also be possible to use already developed training courses for parts of the program. The CEBS and IRS programs are possibilities. Also it may be possible to use the same basic training course for both field staff and appropriate National Office staff such as in the ORI.

2. DEVELOP A TRAINING PROGRAM FOR JOURNEYPERSON AND ABOVE STAFF.

Important as a training effort is for career ladder staff, it is equally important for staff who have reached the journeyperson level and for staff hired at the journeyperson levels in other occupations. There must be consistency of understanding of ERISA between the career ladder staff and their potential peers and their supervisors. If this is lacking, much of the training will be undone on the job when the new staff are told "how it really is".

Such training can be provided relatively inexpensively, but it cannot be ad hoc. A regular schedule must be followed. Training outlines must be provided so that the training can be given with consistency by supervisors throughout the organization.

3. DEFINE TRAINING NEEDS AND PROVIDE TRAINING TO OFFICE OF PROGRAM SUPPORT STAFF AND ADP STAFF.

As soon as the responsibilities of the Office of Program Support are evaluated and defined, it will be important to determine staff training needs of this unit and provide the needed training on a priority basis.

The ADP unit is faced, as Merv. Schwedt indicated in the planning session, with a major training effort if your automation goals are to be realized. It is urged that personal attention be given to this matter by yourself and/or Alan to ensure the organization will have the technical expertise to support the automation effort.

4. DEVELOP, ON A PRIORITY BASIS, A PROGRAM TO ENSURE THAT CURRENT FIELD STAFF IS TRAINED/RETRAINED IN SUBJECT AREAS WHICH REQUIRE IMPROVEMENT.

The current training needs of field staff have been identified and work has been started on providing the needed training. OE staff and each AD should formally review the qualifications and performance of each field staff member and establish the specific subject areas that need upgrading. Once done, decisions can be made on how to provide the needed training most effectively.

This training, and in fact all training, should be designed to measure understanding of the subject matter by the student. Staff must be required to demonstrate adequate understanding before they are assigned work in the subject area.

A final aspect of the training program is to establish a practice in the organization that new initiatives will be launched first by training the staff in what is to be done. No actual on site work should be initiated by untrained staff in a new area of responsibility any more than new staff should be assigned work without adequate training.

As stated at the beginning of this section, the recommendation for a comprehensive career development program is the single most significant recommendation I can make to improve professionalism in the OPWBP.

It is recognized that meaningful actions in this area will be expensive and require additional resources. It is difficult and possibly unrealistic, to speak to improvements, especially in the training and career development area, in this period of great fiscal austerity. After all, training is generally one of the first areas to be cut when budgets must be reduced.

However, if OPWBP professionalism is to be improved a start must be made. Difficult choices must be made to divert time, effort, money and, most importantly, management committment and attention to training and career development on a continuing basis. The fact that all that is desired and needed cannot be done as quickly as was hoped is not a valid reason for not starting efforts now to improve the organization's professionalism if that is truly an important objective.

In any case, what is needed will not be accomplished by a quick fix. The important thing is to make a committment to start and to make a start, however modest. Second, and of equal importance, is the need to make a committment to a long term continuing effort for career development as a priority equal in importance to producing the day to day work product.

Without both commitments there can be no significant and continuing professional growth of the OPWBP.

INITIATING ACTIONS TO IMPLEMENT TRAINING RECOMMENDATIONS

1. Establish the Assistant Administrators, under the Chairmanship of the Deputy Administrator for Program Operations, as the OPWBP Career Development Committee.

2. Secure technical assistance by detail or contract to develop a statement of the training needed and competence to be demonstrated on the job to achieve full performance status in the pension program

3. Use the product of 2 as a recruitment tool and as a contract with newly hired pension staff.

4. The OPWBP Career Development Committee should commission and approve training programs for journeyperson and above staff both in the individual office and OPWBP

wide. Particular and immediate committee attention should be directed to the training needs of the Program Support, ADP, and current field staff.

5. Establish performance standards for each manager reflecting his/her specific responsibility in the career development program each fiscal year.

D. Job Definition and the Work Environment

Effective recruitment and first class training are not enough. The third necessity is to ensure that individual jobs are meaningful and challenging. In a new program, it is necessary to maintain central control of decision making until guidelines for delegation can be developed. After ten years, the question is whether there is sufficient authority assigned to individual positions.

Several reports have indicated that there has been excessive review of Field work products. The Transition Committee Report lists up to seven levels of review. The elimination of regional offices will go far to correct this problem. In the National Office there is a question as to both supervisory review levels and whether the legal reviews of decisions needs to be as extensive as is currently the case.

It is recommended:

1. CONDUCT A REVIEW OF THE CURRENT REVIEW LEVELS TO DETERMINE THE APPROPRIATE LEVEL OF AUTHORITY WHICH SHOULD BE ASSIGNED TO POSITIONS AT EACH LEVEL IN THE ORGANIZATION.

   Unless the individual employee believes that what he or she is doing is important and significant there will be little motivation to do a good job and there will be little feeling of professionalism in the organization. It is not reasonable to expect extra effort and pride in the work product if there are routinely several levels of review before the work product is accepted and used. Beyond the subjective question of motivation there are, of course, the more measurable costs of review.

   Decisions on review levels will not be an easy task to accomplish. The impact and risks of decisions must be defined so that levels of authority can be assigned.

   A related issue to be addressed concurrently with the review issue is the level of and amount of detail required in reports. The question is how much time should be devoted to documenting the judgements of the full performing professional.

2. GIVE CAREFUL CONSIDERATION TO THE ORGANIZATIONAL IMPLICATIONS OF ESTABLISHMENT OF GS-13 NON-SUPERVISORY POSITIONS IN THE FIELD.

   It is likely that it will be possible to identify enough GS-13 work in the enforcement position to support a GS-13 grade level. If the current study determines that this is in fact the case, great care should be used in reorganizing work assignments in the field to support such a grade level. The following guidelines are recommended:

   -- The distribution of duties between positions should be such as to inhibit program changes for fear that program changes will endanger staff grades. If, for example, criminal investigation in certain industries is work which warrants GS-13, it will become more complicated to change the emphasis on such work if the grade level of a number of positions is dependent on its continuation.

   -- The increased salary costs must be weighed against expected program improvements.

   -- Care must be taken to ensure that meaningful distinctions can be made between positions at different grade levels. Nothing is more destructive of morale than the situation where people at different grade levels cannot see a difference in their responsibilities. This problem is so significant that it is recommended no GS-13 non-supervisory positions be established until clear and realistic guidelines are accepted by the staff.

3. ESTABLISH A LIMITED NUMBER OF TECHNICIAN POSITIONS IN THE FIELD.

   The current concern with the grade bulge in grades GS 11-15 requires that OPWBP address this issue. Discussions indicate that there is potential for using technicians in the field program, thereby conserving the time of the higher cost professional staff. Such arrangements should be tested on a limited basis, primarily assigning staff who are not placed as the reorganization is fine tuned.

   Another way to increase the productivity of senior staff is through the use of volunteers. Relatively simple arrangements can be made with colleges to provide non-paid job assignments for students. If keyed to students who will meet upon graduation the certification requirements for investigator, a volunteer program can be a valuable part of a recruitment program.

INITIATING ACTIONS TO IMPLEMENT JOB DEFINITION RECOMMENDATIONS

1. Based on the work of the Transition Committee, OE should revise the criteria for case documentation and case review and review to provide maximum authority and responsibility to the full performing investigator, the Track Supervisor and the Area Director.

2. In connection with actions taken under Initiating Actions to Implement Staffing Recommendations, ORI should define the level of authority to be assigned to the full performing professional, the Division Chief, etc.

3. OE should develop:

   -- An Area Office Table of Organization and Grade.

   -- Work assignment guidelines for staff at each grade level before any non-supervisory GS-13 positions are authorized.

4. Request the OASAM to classify a technician position for use in the Area Office.

   -- OE should allocate such a position to selected offices.

   -- OE should review the value of the technician position after one year.

E. Performance Management and Accountability

The exercise of clearly defined authority must be monitored and evaluated to ensure that it is being properly applied.

1. USE THE PERFORMANCE APPRAISAL SYSTEM FOR WORK MANAGEMENT

   Research results in DOL indicate that there are a number of positive results--all contributing to increased professionalism--when the performance appraisal system is used for management of the work process rather than solely as a personnel technique to be applied once a year.

   -- There is a belief that the supervisors expectations are better understood.

   -- There is a higher level of trust in the supervisor.

-- There is greater acceptance of performance ratings.

-- There is greater pride in organizational and personal performance.

Standards for management staff should include responsibility for both day-to-day and, for higher level management, the established organizational improvement goals.

Finally, it has been demonstrated in DOL that one of the greatest single factors contributing to effective use and acceptance of the performance appraisal system is meaningful participation by both parties in the process. Neither unilateral supervisory definition of standards, nor unquestioning supervisory acceptance of subordinate-developed standards can be considered meaningful participation. There must be joint discussion leading to understanding, if not acceptance, of supervisory expectations for there to be meaningful participation.

INITIATING ACTIONS TO IMPLEMENT PERFORMANCE MANAGEMENT RECOMMENDATIONS

1. The Deputy Administrator for Program Operations should issue guidance to incorporate accepted organizational improvement efforts in performance standards of the responsible managers.

2. The Administrator/Deputy Administrator for Program Operations should establish from the top down the practice of joint participation in developing performance standards and regular, at least quarterly, serious discussions of progress, problems, and revision.

   -- Management guidance should be issued establishing this on the desired practice throughout the organization and subordinate managers held accountable through a performance management performance standard

ORGANIZATIONAL ARRANGEMENTS

A. National Office

The National Office organizational structure developed for the reorganization raises no new concerns. The only issues I would mention are the two already addressed at your planning session--establishment of a separate management office as part of the Office of the Administrator and a review of the basic functions of the Office of Program Support.

In the field, the over-riding need is to determine the location of the Area Offices to bring the current period of uncertainty to an end.

I strongly advise that the above three organizational issues be addressed on a priority basis, decisions made and implemented, and then a moratorium be declared on future organizational change at least at the first level below the Office of the Administrator. It is my experience that organizational changes do not solve problems; people do. A period of organizational stability is needed to enable staff to learn their redefined jobs and for the development of new working relationships. Only after a year or so of experience in a relatively stable organizational environment can there be, in my judgement, a realistic judgement as to whether the organizational structure is aiding or hindering program accomplishments.

Specific organizational recommendations are:

1. ESTABLISH A MANAGEMENT OFFICE REPORTING DIRECTLY TO THE ADMINISTRATOR/DEPUTY ADMINISTRATOR FOR PROGRAM OPERATIONS

   This action was recommended in the long range planning sessions and I assume accepted. The definition of the responsibilities of such an office has to be developed with care. The current OMB emphasis on centralization of administrative services precludes simple adoption of the standard DOL model.

   The basic guideline recommended is that technical support and advice and paper work be the responsibility of the NCSC, while the OPWBP management office responsibility be directed (1) to securing the management decisions needed in program sensitive administrative matters and (2) to tracking the status of actions pending in the NCSC/OASAM.

Some specific examples as to the application of this guideline are:

-- The management office will develop future year budget requests; the NCSC will provide technical assistance in costing proposals.

-- Detailed operating budgets for each major National office component and each Area Office should be prepared by the NCSC in accordance with direction provided by the Management Office.

-- Financial reports should be prepared in NCSC/OASAM. The Management Office responsibility will be to track spending requests and direct the NCSC to reallocate funds as needed.

-- The NCSC/OASAM should prepare detailed space layouts in accordance with Management Office direction.

-- The Management Office should develop the program guidance for performance standards. The NCSC/OASAM should provide the technical guidance and supporting paper work assistance.

The Management Office role and staffing pattern should be designed to preclude the provision of technical assistance. The primary task of this office should be to identify and define the management issues which require the attention of the Administrator/Deputy Administrator and propose action in response to such issues and to manage working relationships on a macro level with the NCSC. The Management Office should not be established as the eye of the needle through which all administrative matters are channeled.

Regarding the need to track actions, there will be considerable competition for NCSC attention. OPWBP is one of many independent organizations receiving administrative support from that organization. And, the NCSC client list is likely to grow. Actions to implement a management decision can never be fast enough no matter how long it took to make the management decision. To provide some objective evidence to the Administrator/Deputy Administrator on the level of service, it is important that the Management Office establish a tracking system on administrative requests pending in the NCSC. This will allow an evaluation of complaints and provide the basis for periodic meetings with the Director of NCSC on the quality of service being provided.

2. CONDUCT A COMPLETE REVIEW OF THE OFFICE OF PROGRAM SUPPORT STARTING WITH A DETERMINATION OF THE BASIC FUNCTIONS WHICH SHOULD BE PERFORMED BY THIS UNIT.

   Again this recommendation has been anticipated in your planning meeting. It is included here only to emphasize the need and to explain the absence of specific recommendations vis a vis this unit. The first order of business must be a redefinition of the responsibilities of this unit before any other questions can be intelligently addressed. The review should include not only consideration of those functions which must be performed, but also the method for accomplishing the function given limited resources. A cost-benefit view should be taken.

   Much of the employee concern, voiced by Local 12, is from this organization and so special attention should be directed to keeping the Local advised. Employees in this unit should be kept advised, through their representatives, of actions being taken.

INITIATING ACTIONS TO IMPLEMENT ORGANIZATIONAL RECOMMENDATIONS IN THE NATIONAL OFFICE

1. Secure by detail a person experienced in administrative functions in the DOL to define the operating role and structure for a Management Office which complements the NCSC. Definition should be in the fiscal, personnel, and administrative services areas.

2. Secure outside assistance to conduct a review of the Office of Program Support:

   -- To examine functions,

   -- To examine work methods,

   -- To examine staffing level and skills requirements, and

   -- To provide specific recommendations.

B. Field Organization

No specific recommendations as to the location of Area Offices can be offered. The decisions here are program calls and my review has not been of sufficient depth to allow any recommendations. However, some guidelines are offered for the decision process and for implementation of the decisions.

- -- No Area Office should be established at a location that cannot support at least two tracks.
- -- A track supervisor should be assigned for eight to ten staff.
- -- If it is decided to assign staff outside of an Area Office, staff should be assigned in sufficient number to warrant assignment of an on-site track supervisor. A ratio of five to seven staff is recommended for an off-site track supervisor to allow time for the administrative duties which will have to be performed at the off-site location.
- -- An administrative assistant should be established in each Area Office to work with the RA. The same quidelines for defining the responsibilities of this position offered for the National Office should be followed. This should be relatively easy to work out as LMSA relied heavily on the RAO for administrative support and did not seek to duplicate services.
- -- The Area Office should be formally established as soon as possible after it is identified and all staff assigned outside the designated Area Office cities should be immediately assigned to the Area Office.
- -- Actual physical moves should be phased in over a six to twelve month time period and be the responsibility of the Area Director to arrange. This will provide the current staff time to assess the changes made to their duties through the training and retraining efforts and to make informed career choices regarding required moves.
- -- The redefined Area Office should be established as the competitive area for reduction in force purposes.

ADMINISTRATIVE ARRANGEMENTS

As a new organization, OPWBP needs to give considerable initial attention to administrative arrangements both within the organization and with OASAM. The administration effort to reduce administrative overhead costs requires that these arrangements be developed so as to balance cost and service to a degree not hitherto necessary. Also, regularized procedures are necessary to minimize the time, attention, and energy which top management finds it necessary to devote to these matters.

Two general recommendations have already be offered in the discussion of organizational arrangements. One is that there be a clear definition of responsibility between the OASAM support units and the management staff of OPWBP. Given its limited staff, OPWBP should make every effort to obtain non-program staff expertise from outside of its own staff resources. Further, any staff identified as being basically a technical administrative support position is very susceptible to elimination as staff is cut in the administrative area.

The second guideline, already offered, is the need for the OPWBP management units to develop simple straightforward tracking systems to use in working with the central administrative units. Unless there is accurate data, there will be little chance of an effective working relationship being developed. The inevitable arguments will not be able to focus on correcting a problem and will be more concerned therefore with assigning blame.

Beyond these general guidelines, it will be necessary to make changes in administrative procedures. The savings being demanded in this area are simply not to be gained through consolidation alone. Less labor intensive procedures must be put in place both for OPWBP and for central administrative units; changes which will impact on the program manager.

Specific recommendations which should be addressed on a priority basis are:

A. DEVELOP A STANDARD ORGANIZATION AND GRADE STRUCTURE.

Considerable time and effort can be saved if the organization and grade structure is centrally established and maintained for each unit. Standard position descriptions can be prepared and classified. While consideration can be given to exceptions to the standard pattern, it should be made clear that exceptions are just that.

B. ESTABLISH A SINGLE POINT OF CONTACT FOR PROVIDING WORK GENERATING ASSIGNMENTS TO THE FIELD.

While it is very appropriate that the various National Office units provide technical guidance directly to the Area Offices, any communication that requires a work product and reply to the National Office should be sent by the Office of Enforcement. That is the only way to control the volume and nature of requests to the Area Offices.

C. AVOID DEVELOPING SPECIAL POLICIES, ESPECIALLY IN THE PERSONNEL AREA, FOR OPWBP.

To the maximum possible extent, OPWBP should follow the Department's policies without alteration or addition. The cost of developing such policies is considerable. Even greater is the the cost of administering agency specific policy. Staff expertise must be provided by the agency and the job of the central administrative units is made more time consuming and expensive.

D. PROVIDE CLEAR AND DEFINITIVE DELEGATIONS OF ADMINISTRATIVE AUTHORITY TO KEY MANAGERS AND ESTABLISH ACCOUNTABILITY FOR THE EXERCISE OF THE DELEGATIONS.

As recommended in the comments on job definition and accountability, the delegation should be as great as possible. Managers should be responsible for sound decisions in the administrative area as in the program area. The responsibilities should be defined, training should be provided, and standards for performance established.

INITIATING ACTIONS TO IMPLEMENT ADMINISTRATION ARRANGEMENT RECOMMENDATIONS

1. Request an OPWBP Area Office to develop, in coordination with a Regional Personnel Office, standard position descriptions for the Area Office. Subsequently, initiate the same action for National Office units.

2. O/E should develop, for each Area Office, a staffing table showing positions at each grade level.

3. Request OASAM assistance in preparing delegations of administrative area. The report of the Transition Committee provides a good base line for this work for both National Office and Area Office managers.

. CONCLUDING COMMENTS

You asked for any suggestions I might have on ways that OPWBP can show leadership on pension issues in the broader community. A few suggestions have occurred to me.

-- The research and long range policy areas offer a good opportunity. An effort can be made to provide direction to the research and policy issues being addressed by other Government agencies and non-Government groups. The Forum offers a vehicle for such an effort in the private sector. Creation of a parallel group of representatives from selected agencies could be used to provide pension program leadership in the public sector.

-- Regular contacts with research staff in agencies such as the BLS, SSA, Department of Commerce, CBO, and the IRS offer an opportunity to provide leadership in developing the issues which will be explored and offered for public education and debate as pension policy is considered.

-- Regular temporary appointment of one or two persons in OPWBP, qualified in pension issues, to address a key question where an outside perspective would be valuable. One way to attract greater attention for such appointments and possibly secure a wider group of interested top quality candidates would be to announce a competition for an OPWBP fellowship. Each year a topic of interest could be selected and interested persons invited to compete for selection. Beyond the work product obtained, there would be an increased awareness of OPWBP as an organization in the private sector.

-- The quarterly staff conferences recommended in the training section of this memo can include discussions by non-OPWBP and non-DOL persons. Not only will OPWBP staff receive a different perspective on pension issues, but the person making the presentation will be exposed to the organization and a good cross-section of the key staff in it.

-- Finally, consideration should be given to establishment of a more visible public information program to spread the word on OPWBP accomplishments.

Pension Fund Investments and Corporate Governance; Hearings

Pursuant to section 513 of the Employee Retirement Income Security Act of 1974 (ERISA) 29 U.S.C. 1143, public hearings on pension fund investments and corporate governance will be held by the Office of Pension and Welfare Benefit Programs beginning at 9:30 a.m. on Wednesday and Thursday, January 9 and 10, 1985 in the Terrace Room, Plaza Hotel, 768 Fifth Avenue, New York, New York and at 9:30 a.m. Monday and Tuesday, January 14 and 15, 1985 in the Washington Room, Holiday Inn, 750 Kearny Street, San Francisco, California.

The hearing will be concentrated on two subjects. The hearing on the first day in each city will concentrate on the investment performance of pension funds. It will explore various aspects of pension fund performance. Among the questions to be explored are the following:

1. What has been the historic performance of pension funds?

2. How has this performance compared to the performance of other institutional investors and indices (e.g. mutual funds, U.S. Treasury bills, S&P 500, consumer price index)?

3. To the extent there is any difference between rates of return earned by pension funds and other investors, what may explain the difference?

4. Is there any reason to believe in light of overall rate of return experience over the past 30 years, that an active investment policy for pensions has produced superior results to a passive (index fund) investment policy, after management and turnover costs are netted-out? Is there any evidence of a difference in results for pension plans actively managed by in-house managers from results of pension plans actively managed by outside investment managers?

5. What is a legitimate target rate of return for a pension fund? Why?

6. What is the relationship of investment performance of pension funds to participant benefits?

The second day in each city will be devoted to issues relating to the role of corporate pension funds with respect to issues of corporate governance. The Office of Pension and Welfare Benefit Programs (OPWBP) wants to develop a record on the experience of those pension funds that have been actively involved in corporate governance issues, including especially:

1. Voting on proposals of management to discourage takeovers (such as "fair price" provisions, "super majority" provisions, and the creation of new classes of stock).

2. Initiation or participation in shareholder initiatives relating to corporate governance (such as initiatives relating to executive compensation, "targeted buybacks," or requirements for committees composed of outside directors to consider merger offers).

3. Voting on other matters which may be brought before corporate shareholders.

OPWBP is especially interested in testimony concerning the basis for those investment managers' decision to take an active role in voting shares, the basis for selecting the proposals or initiatives to vote on, the process for determining how to vote in each particular case, the difference (if any) in voting shares held by a pension fund versus shares held in other fiduciary capacities, and decisions to take action beyond voting, such as bringing or joining in a lawsuit against management.

OPWBP emphasizes that its purpose is to explore the experience of those managers that have taken a role with respect to corporate governance.

Individuals, or representatives of organizations wishing to appear at the hearing on any of the above issues should submit written requests to be heard, copies of their statements, and an outline indicating the time to be allocated to each topic, on or before December 28, 1984 to Edward F. Lyczak, Office of the Administrator, U.S. Department of Labor, Room S-4522, Third and Constitution Avenue, NW., Washington, D.C. 20210. Telephone number (202) 523-8753.

Individuals or organizations wishing to submit written statements on any aspect of the hearing should send 10 copies to Mr. Lyczak at the above address. Papers will be included in the record of the meeting if received on or before January 7, 1985.

The Department will prepare an agenda indicating the order of presentation of oral comments and the time allotted to each person making oral comments. In the absence of special circumstances, each commentator will be allotted 10 minutes in which to complete his or her presentation. Information about the agenda may be obtained on or after January 4, 1985, by telephoning Mr. Edward Lyczak at (202) 523-8753. This is not a toll-free number. Individuals not listed in the agenda will be allowed to make oral comments at the hearing to the extent time permits. Those individuals who make oral comments should be prepared to answer questions regarding their comments.

A written record of the hearing will be made.

Signed at Washington, D.C., this 29th day of November, 1984.

Robert A.G. Monks,

Administrator, Office of Pension and Welfare Benefit Programs.

[FR Doc. 84-[illegible] Filed 12-3-84; 8:45 am]

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U.S. Department of Labor

Office of Pension and Welfare Benefit Programs
Washington, D.C. 20210

Enclosed for your review is a summary of the hearings conducted in New York and San Francisco by the Office of Pension & Welfare Benefit Programs (OPWBP) in January 1985. This summary was prepared by Robert Monks, the former Administrator and Janet Brown, Special Assistant to the Administrator. A copy of the transcript of the hearings and materials submitted for the record are available for review in OPWBP. The Department welcomes your comments on the summary. Written comments should be directed to the Office of the Administrator, OPWBP, 200 Constitution Avenue, N.W., Room S-4516, Washington, D.C., 20210. The record of the hearings is in the process of final verification by the participants. When this process is complete a final summary report will be compiled with new page references and amended quotes as necessary.

UNITED STATES DEPARTMENT OF LABOR
OFFICE OF PENSION AND WELFARE BENEFIT PROGRAMS
PUBLIC HEARINGS

NEW YORK CITY 1/9 and 1/10/85
and
SAN FRANCISCO 1/14 and 1/15/85

Summary of Conclusions from Hearings

I. Prologue

In January 1985 the Office of Pension and Welfare Benefit Programs (OPWBP) conducted Hearings focused specifically on investment performance and governance issues. The scope and quality of both written and oral presentations provided valuable insight into the nature of the American private pension system under the Employee Retirement Income Security Act (ERISA). The concerns voiced served as compelling reminders that there has been no comprehensive oversight review of ERISA since its passage more than a decade ago.

OPWBP Hearings - Conclusions

The Congressional consensus that accounted for ERISA's passage was slender. We are told that Congress knew that it was conferring identical jurisdiction on two federal departments; it also acknowledged that the Act contained no explicit retirement income policy objectives. Simply stated, Congress could not agree to anything else, and flawed passage was considered preferable to no passage. With the departure of Senators Williams and Javits and Congressmen Burton, Dent, and Erlenborn, there is no longer an institutional memory in the national legislature regarding ERISA. This situation is increasingly true among committee staffs as substantive issues have been claimed by finance-oriented committees. In recent years, there has been extreme reluctance to "open up ERISA", largely because no one feels comfortable with the statute, and therefore wouldn't want to vote on amending it.

It is not hard to understand why there have been so few detailed inquiries into the industries fostered by ERISA (hereinafter referred to as the "industry"). The legal and administrative structures of ERISA are intricate to the point of discouraging any but the indomitable. The language is confusing, full of special purpose acronyms (PBGC, SOL, OPWBP), legal shorthand (exclusive benefit rule, prudent man rule), and special numbering (Title I, S406(b), S408); that ERISA fiduciary considerations are to prevail over all other public policy interests is unmistakable, but the implications are not spelled out. The law is all-encompassing; its impact on American society ten years after passage can only be guessed.

Congress' determination that ERISA funds were to be different from other funds, and that a trust relationship was to characterize all dealings with reference to ERISA assets, are plain in the statute. That ERISA was to preempt all state laws that purport to regulate employee benefit plans is likewise clear. Yet we can only begin to articulate a few of the unmistakable consequences of ERISA; savings are considered to be interchangeable with pensions in providing for retirement; tax-aided savings schemes have grown beyond anyone's contemplation, raising the spectre of a new Gresham's law in which savings that are not tax-aided would be driven out of existence.

The original division of ERISA administration between a new federal corporation and two existing departments was a source of confusion that has only mildly abated over the last ten years. Oversight and legislative responsibility for ERISA is spread among a variety of Congressional committees, each focusing on discrete aspects of the industry: these include operating expenses, enforcement, relationship to other retirement income programs, labor relations, and tax cost.

OPWBP Hearings - Conclusions

There is no committee responsible for all of ERISA, which is why so many important issues are "lost between the cracks" of conventional oversight.

The industry has gotten so large -- it is estimated that ERISA assets will comprise more than half of all debt and equity in the United States by the turn of the century -- that the mere fact that such a significant proportion of the nation's assets are considered "special" is a growing problem in itself. The classic definition of a trustee's duty is that he is to have "morals, above the morals of the marketplace"--how will this be possible when the "res" of the trust is so large that it literally constitutes the market place?

As it involves more than one trillion dollars in liquid assets, the industry is one of the largest in America today. OPWBP estimates that this figure will rise to three trillion (in constant dollars) over the next fifteen years. Consider what this means:

° In many cases, the value of a company's pension plans is greater than the market value of that company's assets, even if it is a large entity.

OPWBP Hearings - Conclusions

- Expenses for employee benefit plans are the second largest source of business expense (after direct salary); tax deductions for the industry are the largest single federal income tax reduction.

- Institutions are becoming the dominant factor in stock trading markets, and pension plans are the dominant institution.

- The industry is collectively the largest shareholder in corporate America; indeed, its ownership percentage has reached the level that no reference can be made to the ownership or governance of corporations without taking pension plans into account.

- The industry will be the preponderant source of new financing for American industry. Clearly, the amassing of such a sum of assets under a new and largely exclusive law has led to predictable confusion.

ERISA attempts to do many things. It makes employee benefit plans special and applies complex procedural and substantive burdens without differentiating (except in applying some technical rules) between plans that are essentially equivalent to savings (defined contribution) and those with traditional pension characteristics (defined benefit). Mechanisms that permit the tax-free investment of funds are popular and Congress has enthusiastically manufactured new ones and enhanced the attractiveness of old ones, e.g., IRAs and Keoghs, §401(k) and ESOPs. Vast cash flows have been redirected into these new vehicles, all of which are nonetheless subject to ERISA.

Policy contradictions are inherent in these various schemes. The considerations that lie behind making an individuals' pension independent of the economic fate of the sponsoring company are contrary to those behind profit sharing and employee participation plans; the former are intended to protect pension funds from the employer's business downturns, while the latter are intended to encourage employees to share the gains (or losses) of their employer. Even-handed application of the law to both savings and pension plans can only be "benevolently arbitrary" in the absence of a policy suggesting their relative priority.

ERISA mandates that all plans have a fiduciary and that the fiduciary comply with strict standards of conduct. It goes on, however, to permit the delegation of fiduciary responsibility. The status of a fiduciary seems unenviable: incentive compensation for superior performance, if permitted at all, is certainly confined; liability for error is vast. What seems to have happened is that those who are primarily responsible -- the plan sponsors -- have been more concerned with insulating themselves from liability than with involving themselves in the process of obtaining superior results. In the process of demonstrating "prudent" conduct, the majority of ERISA fiduciaries have therefore called in "expert" consultants. The apparent result can hardly be that intended by the ERISA sponsors: a system with little incentive for superior performance and unusually high operating costs, all to insulate against the strict level of liability mandated by statute.

ERISA reflects a voluntary policy: no company in America is legally obligated to create pension plans, and having done so, no company is legally obligated to continue them. Thus, all who are subject to ERISA have chosen to be so. This has created a strange disequilibrium: failing pension plans are guaranteed by the government; plans successful beyond the actuarial commitments create value -- tax-free -- to which plan sponsors have access at any time. Stated boldly, the burden of ultimate failure in investments is the government's, the benefits of success are the plan sponsors'. Perhaps incentives of this kind are necessary to induce so many firms to create pension schemes voluntarily. By all statistical measurements, including the number of plans, the levels of vesting, the number of participants covered, and the volume of aggregate assets, the American pension system has grown over the ten years of ERISA. Whether these statistics translate into the responsible conclusion that the impact of ERISA on retirement policy is cost-effective remains to be proven.

Testimony provided by service providers must be viewed against the backdrop that those providing services to ERISA plans have prospered. One concludes that service providers, while well paid, have been conscientious in their efforts to carry out the statutory policy. The problem in interpreting testimony arises from the understandable tendency of each "expert" to view the ERISA world from his own perspective. No single institution in the private sector is responsible for considering whether the system as a whole makes sense, or whether particular aspects of it could be accomplished more economically.

The picture, then, is one of a statute that is not understood and that contains internal contradictions; unprecedented asset pools; professional service providers responsible for compartmentalized duties; no special rewards for superior performance and perceived strict accountability for deficiencies; no oversight for the system as a whole; no statistical basis for comparing the costs and benefits of the system; no differentiation between the desirability of savings or pensions.

In effect, ERISA created a new world which is considered "legitimate" because it provides retirement income. Since the statute doesn't define "retirement income", all are free to adopt their own definitions, to pursue their own goals, and to declare in all sincerity that they have been successful. Coincident with the passage and growing importance of ERISA, there has been an increase in daily trading on the New York Stock Exchange to 100 million-share volumes per day, annual turnover rates for ERISA funds approaching 70%, and a frenzy of corporate take-overs. Whether there is any correlation between these developments should be considered further.

The OPWBP Hearings do not provide the many answers that together would give a comprehensive picture of the health of retirement income programs in America today. Because of the extraordinary generosity of the participants, who openly and thoughtfully shared their knowledge, it is possible, however, to suggest certain conclusions. It is hoped that these Hearings will stimulate further investigation by branches of government with greater jurisdiction and resources, for the issues reach far beyond DOL's responsibilities. The Hearings provide the opportunity to reflect, speculate, and hazard conclusions as to the impact of ERISA on various aspects of retirement income policy and practice, as well as on the specific subjects of investment performance and governance. They also suggest the necessity of joint evaluation of ERISA by the Executive Branch and Congress.

The summary that follows is cast in two parts: the first is a consideration of investment performance and corporate governance, and the proposal of certain institutional mechanisms for their future study; the second is an effort to analyze the wide range of testimony in an effort to understand what the real impact of ERISA has been.

II. Hearings

The Office of Pension and Welfare Benefit Programs (OPWBP) of the Department of Labor (DOL) is responsible for administering Title I of the Employee Retirement Income Security Act (ERISA) of 1974. In order to improve understanding of its responsibilities in this area, OPWBP held Hearings on the investment and voting of securities that are subject to ERISA.

OPWBP Hearings - Conclusions

By Federal Register notice, OPWBP solicited expert testimony on these issues. During the first set of Hearings in New York, twenty-six individuals testified personally and two submitted written statements. In the San Francisco Hearings, there were twenty-three submissions. The Department is very grateful for the scope of the testimony submitted, the range of viewpoints represented, and the care that went into preparing testimony on such a difficult subject.

The witnesses included:

State Treasurers

Henry Parker of Connecticut

Jesse Unruh of California

Money Managers

Dean LeBaron
of Batterymarch Financial
Management Corporation

Peter Vermilye
of Endowment Management
& Research Corporation

Roger Bransford
of Meridian Management
Company

David L. Heald
of First Chicago Investment
Advisors

William D. Witter
of William D. Witter, Inc.

Richard Barker
of Capital Guardian Trust
Company

Theodore M. Theodore
of Morgan Stanley Asset
Management

John Kennedy
of H.J. Meyers & Co.

Lloyd McAdams
of Security Pacific
Investment Managers, Inc.

Herbert M. Hanson
of Hanson Investment
Management Co.

Alan G. Seidner
of Alan G. Seidner
Investment - Financial
Consultants

Douglas Dorn
of Dorn & Hellison

Arthur Williams III
of Merrill Lynch

Jeffrey Diermeier
of First Chicago Investment
Advisors

Kenneth Cutler
of Cutler & Co.

Vernon S. Hodge
of William M. Mercer -
Meidinger, Inc.

John Crichton
of Commonwealth Group

Lambert C. Thom
of Bangert, Dawes, Reade,
Davis, & Thom, Inc.

John Hartz
of Mutual Life Insurance
Company of New York

Ralph L. Knisley
of Irving Trust Co.

Lawyers

Hugh Calkins, Esq.
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Pogue

Alvin D. Lurie
of Meyers, Tersigni,
Kaufman, Lurie, Feldman
& Gray

Frank Cummings
of Cummings & Kershaw, P.C.

Christopher J. Sues, Esq.
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Professors

Dennis Logue
of the Amos Tuck School
of Business, Dartmouth
College

Stephen Ross
of Yale University

Joseph Auerbach
of Harvard University

Marshall Blume
of The Wharton School,
University of Pennsylvania

Roger Murray
of Columbia University

David Ratner
of Cornell University

OPWBP Hearings - Conclusions

Myron Scholes
of Stanford University

Robert M. Soldofsky
of University of Iowa

Roy Schotland
of Georgetown University
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Consultants

Dennis Tito
of Wilshire Associates

Sophie Korczyk
of Employee Benefit
Research Institute

Hillel Gray
of Investor Responsibility
Research Center

Peter O. Dietz
of Frank Russell Co., Inc.

James E. Heard
of Investor Responsibility
Research Center

Irving Baldinger
of American Benefit
Plan Administrators

Stephen Berkowitz
of Berkowitz, Logue &
Associates, Inc.

Donald Korn
of Arthur D. Little, Inc.

Thomas Brophy
of Moseley, Hallgarten,
Estabrook & Weedon

Jack Treynor
of Treynor-Arbit
Associates

Louis O. Kelso
of Kelso & Co.

Douglas Borton
of Buck Consultants, Inc.

Plan Sponsor

Graham O. Harrison
of U.S. Steel & Carnegie
Pension Fund

Public Retirement System

Clark Manning
of Teachers' Retirement System
of Texas

Plan Administrator

George W. Lehr
of Central States, Southeast &
Southwest Areas Pension Fund

III. Summary of Conclusions

The conclusions derived from written submissions and the Hearing transcripts can be summarized as follows.

A. The Hearings manifested that there are no policy objectives, no measurement system that is uniform in the industry, and no substantial body of data that reports performance in a consistent manner, and that no conclusions can be drawn as to the absolute value of asset management. Therefore, it is not possible at the present time to conclude that the costs (meaning the revenues foregone by the Treasury Department) of ERISA are justified by its benefits in creating retirement income for Americans.

OPWBP Hearings - Conclusions

B. ERISA requires that fiduciaries act prudently with respect to assets under their trust, including the right to vote shares of stock. Current institutional arrangements which customarily delegate voting rights to money managers are not effective for a variety of reasons, including, in some circumstances, serious conflicts of interest. It is clear that plan sponsors need to act with a greater proprietary sense, possibly by retaining voting rights and by developing new institutions to articulate ownership rights in a way that protects plan beneficiaries.

C. Department of Labor (DOL) must improve management of ERISA annual report data (Form 5500 information). Complete, timely statistics are critical to informed decisions regarding the costs and benefits of ERISA.

D. DOL must act as a catalyst in encouraging private industry to develop common standards of measurement for ERISA fund performance.

E. DOL should consider promulgating regulations clarifying the obligations of fiduciaries to exercise voting rights of portfolio holdings. Specifically, DOL should consider issuing a regulation under Section 404(c) to define voting responsibilities under self-directed plans and the extent to which they apply to ESOPs.

F. DOL should assist plan sponsors in developing one or more self-regulatory organizations (SRO) in order to make private sector expertise available in analyzing increasingly sophisticated ERISA proposals.

The most important aspect of the testimony is the insight that the material as a whole provides on the workings of the industry under ERISA. The testimony serves as a framework within which one can consider the range of possible answers to the questions posed in the Federal Register Notice of Hearings. Analysis of the testimony is therefore organized to consider: problems created by the statute's "incentive to delegate" and the according need for renewed involvement by plan sponsors; the lack of explicit goals for retirement income and its impact on investment performance; and shareholding owners' need for a new way to express their interests.

IV. Fiduciary behavior under ERISA: the need for involvement by plan sponsors as proprietors

A. Delegation of responsibility

In defining appropriate fiduciary conduct, ERISA mandates a "process" rather than any particular objective standard. The Act requires that each plan have a trustee, that the trust relationship be formally set forth in writing, and that the trustee accept his responsibilities. In effect, the Act is designed to be insurance against the worst abuses dealt to employee benefit plans prior to 1974.

The focus on process has resulted in several sequential delegations of responsibility. In the first instance, plan sponsors have delegated substantial responsibility for managing both parts of plan assets: the material value and the voting right that pertains to shareholdings. The latter problem is addressed in section VI of this paper. The former affects return on investment, which will be discussed here.

It was widely acknowledged by witnesses that plan sponsors do pass on much of their fiduciary responsibility, and that, indeed, they would be foolish not to. [1] ERISA fixed a level of accountability with respect to employee benefit plans that can be bypassed through the reasonable delegation of responsibility (specifically authorized under ERISA[2], although forbidden of a fiduciary under the common law). As Professor Stephen Ross wrote: "The division of [the legal fiduciary] responsibility between the sponsor and others had already been determined competitively and the law, by raising the sponsor's share, had predictable consequences."[3] In the views of Professor Ross and others[4] these consequences include: the development of a redundant consulting industry ("ERISA is a make-work program for pension fund consultants"[5]), the concentration of the money manager industry (can you be criticized, to say nothing of being

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[1] Hearings on Pension Fund Investments and Corporate Governance before the Office of Pension and Welfare Benefit Programs, U.S. Department of Labor (hereinafter referred to as "Hearings"), transcript, 1/9/85, p. 73, Professor Stephen Ross. "Rather than shouldering the responsibility itself, a sponsor would be irresponsible if it didn't call in a consultant on whom it could lay off risk."

Hearings, transcript, 1/9/85, Christopher J. Sues, Esq., p. 251. "Rather than focusing on what is good for the fund, taking an active role in getting a proper rate of return...your focus is 'I am not liable; ...let them do it. I can pay them $35,000 a year to lose my money but they are the
(Footnote Continued)

(Footnote Continued)
best in the industry...So we will just let them do it.' I see it as an abdication problem."

[2] Hearings, transcript, 1/14/85, Herbert Hanson, p. 231. Answering Deputy Administrator Lebowitz' question as to why the consulting industry has grown so much over the last ten years. "And I think one of the reasons is because...of ERISA, maybe they think we are more conscious of the responsibility now and they're looking for that buffer." (emphasis added)

[3] Hearings, 1/9/85, written statement by Professor Stephen Ross, p. 8.

[4] Hearings, transcript, 1/14/85, Professor Myron Scholes, p. 158. "ERISA has brought about a demand for more insurance against suits. For these reasons, it may have contributed to the growth of the consultant, manager searches, evaluation services and style definers."

[5] Professor Stephen Ross, *op. cit.*, p. 8.

surcharged, by picking one of the "big, old and reliable firms?"[6]), and the stultification of new investment ideas. Moreover, delegation makes it increasingly difficult to assign responsibility for any specific acts (or failures to act).[7] No identifiable party is in control. This situation cannot work to the benefit of plan participants.

B. Investment Consequences

The plan sponsor's initial decision to delegate sets off a sequence of hand-offs. Testimony made it clear that in the investment area, "process" has encouraged two developments. One is strict adherence to practicing "conventional wisdom" in the industry. There has been no perceived need to consider absolute values, like a real return after inflation. It has appeared that responsibilities are fulfilled by following the example and approximating the results of the other industry participants.[8] Results, however, historically have not had a direct relationship to any given money manager's level of business. Indeed, incentive compensation is practically non-existent. Though this would seem to be an appealing way to sort out the managers who are earning real returns, the only reference to incentive compensation in the hearings was wistful.[9]

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[6] Hearings, transcript, 1/14/85, Alan Seidner, p. 280. "...often we are passed over for larger firms that have substantial assets under management and a very long history and so on and so forth, because these people on the pension committee are always concerned about their liability...(the) time and effort that they have placed with a consultant is, in essence, an insurance premium that they're paying...if something does go sour--...mismanagement or bad decisions...--they can in fact bring up these various layers of protection."

[7] Christopher J. Sues, Esq., _op. cit._, p. 238. "I think that you really have a situation that has deteriorated to the point that as long as the trustees are walking out of a room knowing that they cannot be held fiduciarially liable or held on fiduciary liability they are satisfied."

Process also results in sheer activity. The herd phenomenon exhibited by money managers has also spilled over into the areas of performance measurement, where teams of consultants join the fray. While the sponsor is presumably concerned only about his plan(s), those whom he has hired as money managers are busy measuring the performance of their overall funds, whose return can be used as a marketing tool. Enter the consultants, who produce elaborate computer charts comparing the relative performance of particular funds. In the absence of uniform performance standards, however, these numbers can prove any desired result (see section V). As a consequence, performance measurement is largely one more "process" that adds only marginal value to the plan.

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[8] Hearings, transcript, 1/9/85, Jeffrey Diermeier, p. 222. "...there is a tendency on the part of the pension plan investment community to look to each other to determine their investment policies as opposed to their own best judgment..."

Professor Dennis Logue, who is conducting a detailed survey of investment practices for DOL, concludes unequivocally that the fault for an unproductive modus operandi is the plan sponsors'. See Hearings, transcript, 1/9/85, Professor Dennis Logue, p. 26.

[9] Hearings, transcript, 1/14/85, Lloyd McAdams, p. 72. "If I do not exceed the objectives for the three-year to five-year horizon, then I get a negative fee, which I will be more than happy to pay to the client. ...I think you might find a lot of people dropping out of the money management business if they had to perform to get paid."

A final aspect of the delegation problem arises from the fact that in making fiduciary responsibilities unmistakably apparent, ERISA seems to have tilted the risk/reward ratio away from accountable sponsor involvement. From the sponsor's point of view, aggressive involvement in corporate defined benefit plans is a risky proposition at best. If he wins, the corporate sponsor may be able to defer the obligation to fund defined benefit obligations; if he loses, he can be held liable and will, in any event, be required to restore the employee benefit plan to the extent he caused losses. The sponsor sees himself (as does the statute) as a guarantor of fund investments, a perception that hardly creates an incentive to be imaginative or to take chances,[10] and that removes inhibitions against delegation.

The result is that the preponderance of ERISA's funds are now, and probably will continue to be, invested in the securities of the largest, least controversial American issuers. With ERISA funds constituting a majority of American investment capital within a few years,[11] it must be asked whether it is in the nation's interest to have seemingly "sterilized" ERISA funds.[12] Predictably, "uncertainty ... by itself has led to increased conservatism in behavior."[13] It is not surprising that this leads to indignation and concern from certain ERISA constituencies who have a direct interest in the investment of funds. "(The)...DOL must bear the greatest share of responsibility for perpetuating the myth that ERISA's prudence rules contain some kind of incorporeal standard that makes anything less then the highest 'prevailing' interest rate an imprudent investment."[14]

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[10] This is ironic since the present situation allows a risk-taking management to exploit the statute to advantage.
Hearings, transcript, 1/14/85, Dennis Tito, pp. 200, 204. "You have an opportunity here for the sponsor to gamble. If the sponsor goes ahead and takes a lot more risk, hires active managers...there may be a windfall and there may be an opportunity to reduce costs or to terminate the plan...your downside is protected in the sense that the corporation has limited liability. But they can terminate their plan if it is not doing well..." In essence, the government guarantees payment in the event of corporate failure and there is no obligation to continue a plan. This gives an enterprising corporation a rare chance to have its cake and eat it too.

[11] Richard A. Ippolito, Pension Economics, Richard D. Irwin, publisher, to be published fall, 1985. See generally chapters 1 and 2.

[12] The legislative history of ERISA makes perfectly clear that the problem of conservative investment of capital was addressed. There is specific permission for plans to adopt a comprehensive investment strategy including a portion for investments with a risk profile that would otherwise not have been suitable under the common law for fiduciary investment.

In addition to highlighting the problems of delegation, the Hearings also yielded a spontaneous (and universal) expression that it is time for the plan sponsor to take back his power, and thereby break the stalemate that results from a well-paid network of service providers who lack ultimate responsibility.[15]

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[13] Hearings, transcript, 1/9/85, Professor Stephen Ross, p. 85.

[14] Hearings, 1/10/85, written statement by Robert Georgine, p. 7.
This perception exists despite DOL's promulgation of a "liberal" definition of prudence under Section 404 and several specific statements by Administrators delineating the permissible scope of "social investing."

[15] Hearings, transcript, 1/10/85, Professor Roger Murray, p. 7. "Those who have the real authority and responsibility are the plan sponsors."
Hearings, transcript, 1/10/85, Clark Manning, p. 168. "I think that we must return the investment responsibility to the boards and the sponsors, fiduciary responsibility, and not to the outside money manager."

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V. Cost/Benefits From ERISA Investment Performance

A. Absence of Policy

The Hearings were replete with expressions that everything is for the best in this best of all possible worlds of ERISA.[16] Expert witnesses testified that the funds with which they were familiar had all performed better than the "averages" and certainly well enough to yield a real return after taking inflation into account. The majority of the testimony was reminiscent of the trite phrase: "If it ain't broke, don't fix it."

Closer scrutiny of the testimony, however, brings to mind another analogy. The hearings were similar to the blind men who described an elephant solely from perceptions derived through touch. The conclusions set forth here are not meant to imply fault, for all the witnesses testified within their areas of expertise. None of the witnesses, however, is concerned with the whole system. Focusing on the specific measurement of periodic investment results, it was clear from the testimony that there are exhaustive analyses of individual funds, but that no public material shows the results for a given plan in its entirety. This metaphor applies to the pension "industry" itself: an extraordinary concentration of talented professionals, each honestly convinced that the excellence of accomplishment from their perspective justifies a similar view of the entire field. Those surest that "it" doesn't need fixing have the least perspective as to what "it" is.

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[16] With the exception of Pete Harrison's experience with securing exemptions for certain real estate investments, no one of the witnesses expressed any concern about the adverse impact of the statute ERISA or the administration by OPWBP on their performance. This fact notwithstanding, one is left with the question of the extent to which the industry and DOL operate in ignorance of each other.

It is clear that very large sums of money are being invested in two legs of the "three-legged stool" of retirement income: savings and pensions. The legitimate question is whether the goal of providing retirement income is being achieved. Or, to return to our earlier idiom, what is the "it" that may or may not need to be fixed? In the words of one witness: "We still have no national consensus of such critical issues as what is the proper relationship among the parts of the so-called three legged-stool, employer-provided pensions, individual savings, and Social Security. What is adequate retirement income? What kind of vesting and portability is appropriate for today's mobile and diverse workforce? How should tax policy be used to encourage these retirement goals and, finally, who in government is in charge of this area?

"Without such a policy there is no context within which to adequately consider the issues of investment performance."[17/] [emphasis added].

The fact is that ERISA's annual cost to the government is somewhat in excess of 43.2 billion dollars a year. The pension system is entirely voluntary; any company is free to have a scheme, or, once having one, to terminate it. This system has resulted in increasing numbers of plans, plan beneficiaries, vesting levels and total assets during the ten years of ERISA. Whether the results justify the cost is not known, since there are no policy objectives against which to measure performance.

In 1984, a member of the Council of Economic Advisors applauded the fact that there is no government "policy" regarding retirement income.[18/] It is difficult to associate with this complacency in the absence of knowing essential facts; for example, what is the balance between savings and real pension holdings? To what extent should post-retirement income replace pre-retirement earings? Should

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[17/] Hearings, transcript, 1/9/85, Roger Bransford, p. 122.

[18/] Senate Special Committee on Aging, Hearings on the Tenth Anniversary of ERISA, September 1984, testimony by William Niskanen.

tax incentives support post-retirement income above a certain level, either in dollars or as a percentage of earlier income? Is there a commitment to provide retirement benefits that are indexed against inflation? At the moment, the government permits vast latitude in allowing tax deductions for funding retirement schemes. Add to this the fact that there is no standard against which to judge investment performance. So all the interested parties have made up their own rules, and mirabile dictu everybody has won.[19/]

B. Industry Prosperity

The underlying explanation[20/] for the confusion in pension investment management is very simply that the majority of the players are prospering and, quite understandably, wish to prolong a development that has brought about such a delightful set of circumstances.[21/]

[19/] Hearings, transcript, 1/9/85, Douglas Borton, p. 92. "...I feel it's not appropriate to set a nominal rate of return as an objective for a pension fund, although for calculation purposes we do have to set one for the purpose of the actuarial evaluation..."

[20/] To call it a rationale or a policy would be a hyperbole.

[21/] Hearings, transcript, 1/14/85, Lloyd McAdams, p. 66.
(Footnote Continued)

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The Hearings were illuminating on several aspects of this prosperity that should be examined. They include the issues of real measurement of pension fund return; focus on short-term investment results; and conflicts of interest.

Performance measurement systems were discussed at great length during the Hearings, and testimony was unanimous on several points. Each measurement system is viewed as a marketing tool rather than a device for common communication. No measurement system consistently examined returns after expenses -- including management and transaction costs -- to say nothing of inflation. Indeed, there is no publicly available source of information with respect to the real rate of return achieved by pension funds.[22]

(Footnote Continued)
"All of these industries have prospered dramatically since ERISA ...all of these industries have gone from rather slow industries to very aggressive, active industries which get a lot of attention and interest."

[22] Hearings, transcript, 1/9/85, Professor Dennis Logue, p. 44. (Question from Monks) "Is there any publicly available information which would give a reliable answer on a true rate of return after expenses for pension funds?"
Professor Logue: "No."

None of the material provided at the Hearings purports to be definitive on the question of pension fund performance -- absolute or relative to indices, other institutions or inflation. The most illuminating material remains the articles of Dr. Roy Schotland, filed with the transcript of the Hearings, and Alicia Munnell, New England Economic Review (July/August 1983).

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OPWBP Hearings - Conclusions

There seemed to be a consensus that professional standards for reporting performance are needed. In a hall full of self-proclaimed free enterprise advocates, there was surprisingly wide enthusiasm for the DOL to serve as a catalyst in developing such standards. Take, for example, the colloquy between OPWBP Chief Economist Dr. Richard Ippolito and Professor Logue:

IPPOLITO:. .[D]o you think that it would be advisable for the DOL to consider amending the annual 5500 reform [sic - report is meant] to require standardized reporting of rates of return?

PROFESSOR LOGUE: My general, philosophic view towards asking the government to do more is to say no. I am a member of the Mount Pelier (phonetic) Society. And from time to time we get a little riled up about the existence of traffic lights.

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There was testimony by Dennis Tito that the TUCs system, now administered by Wilshire, contains performance data in consistent form for a substantial percentage of ERISA Master Trustees.

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In this particular instance there seems to be substantial externality to the value of government data.[23]

Or consider the imprecation of Thomas Brophy: "I think that the industry desperately needs...some kind of cookie cutter that can be placed over the operation of funds as to the amount of money they start with, what the yield is, common estimate of risks that they're taking or not taking."[24]

Much of the agreement of need for a standardized investment performance reporting system subsumed the conclusion that it is generally beneficial for there to be public disclosure of as much pension fund administration information as possible. Specifically, it was suggested that the voting records of sponsors and managers be made public.[25]

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[23] Hearings, transcript, 1/14/85, Professor Dennis Logue, p. 38.

[24] Hearings, transcript, 1/14/85, Thomas C. Brophy, p. 243. See also exchange between Deputy Administrator Lebowitz and Douglas Dorn, transcript, 1/15/85, p. 88, *et seq*.

[25] Hearings, transcript, 1/10/85, Dean LeBaron, p. 66. "Institutions can disclose their own voting practices."
Hearings, transcript, 1/10/85, James E. Heard, p. 139.

OPWBP Hearings - Conclusions

As was evident by the range of witnesses at the Hearings, ERISA plans are ideal clients for brokerage houses, money managers, consultants, and professional advisors of all kinds. The resulting relationships encourage a short-term viewpoint[26] that does not inure to the benefit of plan participants.[27] With tax-insensitive holdings and continuing infusions of new cash, pension accounts may well be the single most important factor in accounting for the vastly increased trading in New York Stock Exchange securities. Yet no one at the Hearings could produce data showing a positive correlation between performance and the level of turnover in an account.[28] Indeed, tax-exempt accounts have become such a large percentage of the total trading market as to cause concern over the level of expense incurred to service this volume.[29]

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[26] Hearings, transcript, 1/14/85, Lloyd McAdams, pp. 65, 66. "Everyone has prospered."
Hearings, transcript, 1/14/85, Kenneth Cutler, p. 178. "Pension funds are the perfect client...they ought to outperform less fortunate competitors."

[27] Ibid., pp. 65, 66 and 178.

[28] Hearings, transcript, 1/14/85, Peter Dietz, p. 124. Peter Dietz said that he did not know of such study and that if he, personally, were able to prove the correlation, he would have published an article himself.

[29] As another sidelight of "non policy," one wonders what has happened to non tax-aided savings. Is there any such thing? Has the massive impact of government subsidized

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Finally, the vast and overlapping network of money managers and consultants tends to create major conflicts of interest among all of the significant participants in the ERISA system.[30/] Banks have "Chinese Walls" to regulate their trust departments; insurance companies have "separate accounts" for fiduciary funds; financial conglomerates have brokerage, consulting and money management subsidiaries. ERISA business is profitable for service providers. Thus, every effort is made to describe the scope of responsibilities narrowly and precisely so as to minimize the impact of legal inhibitions. The result is an aggregate of discrete professional services rather than coherent overall management.

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retirement plans doomed individual efforts to provide for their own retirement security? Recent statistics are illuminating: the March 25, 1985 edition of Forbes reports that by April 15 of this year approximately $40 billion will have been invested in 1984 IRAs and Keoghs; at that time, approximately $140 billion will have accumulated in those two retirement schemes. The article notes that at least one expert says that these funds are set aside mostly by better-off people just putting the first $2,000 of their yearly savings into an IRA for the tax break. These accounts now constitute more than one quarter of individual savings in financial assets.

[30/] Hearings, transcript, 1/14/85, Professor David Ratner, p. 76, *et seq*.
Indeed, conflict of interest was described in the hearings as *the single* reason for poor investment results.

C. Risk-taking

The testimony of several senior ERISA experts was particularly illuminating. Pete Harrison has been the in-house manager for one of the more conspicuously successful private plans (Carnegie/U.S. Steel). In his remarks, Harrison noted: "My conclusion from 30 years in this field is very simple. You should drive as fast as you can, recognizing that snowballs will come through the windshield in July some years, that 13% government bonds will not totally protect an enterprise or its employees for their lifetime, that it is vital each month for the pension checks to clear the bank without your having to sell IBM at 57."[31] The current Chairman of Endowment Management & Research Corporation also stressed the certainty of violent change, even though there is uncertainty from which quarter it may come. He commented on the practice of taking advantage of high interest rates to "dedicate" portfolios: "An essential part of successful investment strategies is flexibility -- the ability to shift assets as prices, values, returns, conditions, and prospects change. Bond immunization denies that need."[32]

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[31] Hearings, 1/9/85, written statement by Graham O. Harrison, p. 6.

The best strategy, therefore, for institutional investors generally is to have quick access to a different investment posture. But is this necessarily a correct posture for pension funds? Pension funds' needs can be simply stated: to provide at minimum risk a series of payments at known future intervals that will have purchasing power bearing an pre-determined relationship to salary levels then obtaining. It is clear that such a security exists in theory: an inflation-indexed U.S. Government bond.[33]

Witnesses' objections to indexed securities, whether indexed to inflation or to a market proxy (S & P or

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[32] Hearings, 1/9/85, written statement by Peter Vermilye, p. 3.

[33] Introducing inflation considerations into investment policy for defined benefit plans is to ask the ultimate and most difficult question. With defined contribution plans, performance risk is all on the individual participants. With conventional defined benefit plans, the sponsor only obligates himself to make fixed payments. Over time, pensions have taken inflation into account by tying payment levels to final salaries. Almost no sponsors, however, have been willing to index payments to those already retired to inflation. An inflation-indexed security would permit this irrespective of the timing of an individual's retirement. The concept of an inflation-indexed security is posed as a "theoretical possiblity" against which to evaluate the risks and returns derived through conventional management.

Wilshire 5000), focused on several factors. Some, such as Harrison and Vermilye, believe that "... over time a minority of managers turn in consistently superior results."[34] The concept of the consistently superior manager is the stuff that maintains this hugely profitable industry.

If the definition of objectives has been accurately stated above, it is difficult to justify taking any risk beyond that necessary to achieve the stipulated goals. In other words, if the inflation-indexed government bond produces exactly the needed results, what excuse can there be to incur any risk to achieve results which are surplus, and therefore by definition not for the exclusive benefit of the plan participants? For whom is the manager managing? The statute and its exclusive benefit rule are unmistakable in stipulating that all plan assets must be held solely for the benefit of the participants. And yet the existence of pension plans is wholly voluntary. Any excesses above vested benefits can be returned to the corporate sponsor in the event that he in his uncontrolled discretion decides to terminate the plan. Many companies have, in fact, terminated their plans in recent months.

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[34] Peter Vermilye, *op. cit.*, p. 5.
Dean LeBaron alluded to the possibility that managers will have to develop new skills, to become active, to learn from the "corporate finance" departments in order to achieve acceptable results: "Finding the unique investment is not necessarily the only way in which one can achieve a target investment return. So institutions may develop some of these corporate skills...free market solutions are likely to arise quicker and probably better targeted than imposed solutions. And so the unbundling or the separation of the franchise, the equity or financial franchise from the control franchise...And there...you have an ideal setup for a market...high demand." Hearings, transcript, 1/10/85, Dean LeBaron, pp. 69-70.

There is an obvious conflict. As Professor Ratner put it: "...[T]he people who are managing the funds do not have the same interests as the beneficiaries of the funds."[35] The "wise men" want to invest pension funds prudently, as prudence has been defined in their other fiduciary incarnations. However, assuming the ERISA pension requirements can be met today by providing the legally required cash flows from government bonds,[36] does not a sponsor and possibly his delegated managers run the risk of surcharge for losses incurred by risks in excess of those necessary to achieve the plan's objectives? If the only use of excess funding is for return to the sponsor on termination, or as a reduction of immediate funding obligations by the sponsor,[37] is there not an actionable conflict of interest in taking risks beyond those involved with a "dedicated bond portfolio?" The inflation-indexed U.S. bond doesn't exist, but the problem of conflict of interest bears substantial further attention. Note that the whole question only arises because there are no explicit policies -- no obligations with respect to percentage of pre-retirement pay or indexation. In this free world, everyone has the impression that their profit maximizing behaviour is in everybody else's best interest. It may just constitute an actionable conflict of interest.

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[35] Hearings, transcript, 1/14/85, Professor David Ratner, p. 76.

[36] As mentioned earlier, the preponderance of "defined benefit plans" today does not require inflation adjustments. These liabilities can be offset with existing government bonds (government bonds are stipulated because they have the lowest risk).

Many of those testifying objected to indexing on the grounds that if everybody indexed, there would be no freely created market values any longer. Thus, the need for statistics becomes the operative consideration.[38] A further concern relates to separating the fate of pension recipients from the rest of the economy. As Professor Scholes put it: "A government issuing a real rate bond with a real rate guarantee could end up subsidizing pension funds."[39] There seemed to be no objection to inflation-indexed bonds from the point of view of achieving pension policy objectives.[40]

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[37] Hearings, transcript, 1/14/85, Vernon S. Hodge, p. 254. "If the plan does well, the sponsor reduced his costs. If the plan does poorly, the sponsor increased his costs."

[38] Hearings, transcript, 1/9/85, Professor Stephen A. Ross, p. 67, et seq.
Hearings, transcript, 1/14/85, Peter Dietz, p. 122.

The unique characteristics of pension plans do not appear to have been taken into account. The assumption that risk/reward calculations suitable for other institutional investors are also suitable for pension plans has not been critically examined. The fact that investment performance of pension plans is less than optimal is at least in part attributable to failure to develop strategies (and securities) appropriate for their particular need.

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[39] Professor Myron Scholes, op. cit., p. 154.
Hearings, transcript, 1/9/85, Sophie Korczyk, p. 169. "All taxpayers would wind up paying higher taxes to protect pension participants in the event of unexpected inflation."
Hearings, transcript, 1/9/85, Professor Marshall Blume, p. 51. "The government is essentially then guaranteeing the real productivity increases in the country."

[40] Professor Stephen A. Ross, op. cit., p. 5. Ross offers the following refinements: "While such [inflation-indexed] bonds offer protection against inflation, they exacerbate the real risks faced by the fund and simply don't address the other matters that should be of concern to pension funds. The risks faced by such funds extend beyond inflation to general questions of the business cycle and of real productivity. It is my view that pension fund investments should be structured so as to protect the fund, the beneficiaries, and the sponsors against undue exposure to these risks and ignoring them by investing in indexed bonds does not accomplish this. An employee with a defined contribution plan, for example, is not well served by an investment policy that in no way hedges against the risk of
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VI. Fiduciary Responsibilities with Respect to Ownership

The structure of ERISA formally requires that a fiduciary take responsibility for trust assets. As mentioned above in section IV, the power to vote is an asset of the trust, and there was testimony on the point that voting power has financial value. Indeed, Dean LeBaron testified, "...it may be possible and desirable to unbundle the institutional proxy vote to rent it to the highest bidder in a market with controlled units, which is currently now being immobilized in the hands of rather passive institutions."[41]

There has been considerable academic discussion as to whether institutional shareholdings should be considered to possess traditional attributes of ownership, such as voting power.[42] Professor Auerbach furnished for the record "The

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(Footnote Continued)
increased unemployment because of downturns in the business cycle."

[41] Dean LeBaron, op. cit., p. 66.

[42] Hearings, transcript, 1/10/85, David Heald, p. 110. "There are provisions that do not pass through to independent money managers the opportunity to vote. A lot of times the voting power still resides at the trustee level..." It is plainly the legal and commercial idiom in the United States that voting power with respect to shares of stock has appertained to their legal owners, be they institutional, or whether the voting power is delegated or retained.

Now and Future Business Corporation,"[43] his working paper which describes an entity that "...would have no 'owners,' and thus there would be an end to corporate attributes arising under that rubric...Shareholder approval...would become obsolete..." Writings associated with Professor George Lodge of the Harvard Business School describe a kind of "communatarianism" in which various corporate constituencies are involved in fundamental decisions, subsuming powers that by tradition were thought to appertain to the owners or shareholders. In so far as such speculation relates to securities held subject to ERISA it must, however, be considered moot.

"The power of the corporation is legitimized by the votes of the individual shareholders. Well it is a fiction, a legal fiction. It is a central part of the acceptance...of the economic tolerance of these units."[44] In hindsight, the impact of corporations in American life has been legitimized by the notion of a management supervised and constrained by an informed and involved cadre of owners. The owners, taking a leaf from Adam Smith's books, were the "public proxies" whose self interest coalesced through an "invisible hand" into the public interest. "The rights and responsibilities of stock ownership are inseparable from the rights to receive dividends and the fruits of retained earnings. Mindlessly voting with boards of directors on all issues is clearly a futile attempt to escape these responsibilities."[45/]

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[43] Professor Joseph Auerbach, remarks, April 30, 1983, Committee on Federal Regulation of Securities, Boston, MA. Furnished to Department of Labor as part of the Hearing Record 1/10/85.

[44] Hearings, transcript, 1/15/85, Professor Robert Soldofsky, p. 22.

The fact of the matter, however, is that while the trustee's responsibility may be clear, ERISA places a premium on delegation which creates confusion as to who actually exercises that responsibility. Voting shareholdings is problematic for several reasons: it is difficult to delegate; it is inconvenient for delegatees to exercise; and it creates conflicts of interest.

Professor Roger Murray articulated very precisely why the voting responsibility is singularly difficult to delegate to money managers:

[45/] Hearings, 1/10/85, written statement by Professor Roger F. Murray, p. 1.

"The investment manager retains his clients and earns his fees by delivering good performance, which is measured against market indexes at frequent intervals. No plan sponsor adds to the performance measure points for thoughtful consideration of corporate governance issues. On the other hand, voting portfolio shares against the anti-takeover proposals of a present or prospective client is seldom perceived as the best way to cement or create a warm relationship. In short, the direction, if any, must come from the plan sponsor and it will eliminate the manager's conflict of interest problem."[46]

The voting right is also inconvenient: no one is paid for the work involved in exercising the franchise responsibility "prudently"; no one is protected against the liabilities that may arise from controversial votes (or the failure to vote); there is no schooling or professional background in "proprietorship"--most decisions are matters of first impression. Also, as mentioned above, the conflict of interest problem pertains to the extent that it appears unrealistic to expect intermediaries to be able to act effectively.[47]

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[46] Ibid., p. 2.

[47] Dean LeBaron states that he had not felt customer pressure on account of his votes (See Dean LeBaron op. cit.,
(Footnote Continued)

OPWBP Hearings - Conclusions

The increase in size and relative importance of ERISA funds has exacerbated the conflict of interest problem. ESOPs are a case in point. Partly as a result of the Tax Reform Act of 1984, which provided significant tax advantages in using ESOPs, they have become "a sophisticated tool of corporate finance."[48] The role of ESOPs in takeover situations has been the subject of some judicial decisions to the effect that "...a corporate officer acting as a fiduciary of a defined benefit plan may not use the plan to acquire shares in the corporation for the purpose or resisting a tender offer." [49] There is vast confusion as to the relative priority of

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(Footnote Continued)
p. 71). However, the written statement of Hillel Gray for the Investors' Responsibility Research Council (IRRC) contains a review of the experience of its entire clientele and concludes that the pressure on managers to approve charter changes is significant. Hearings, 1/10/85, written statement of Hillel Gray, p. 6.

David Heald, op. cit., pp. 103, 104. "We have had certain situations where there were apparent threats...suggesting to us that if we proceeded with our particular position they might want to find another commercial banking arrangement."

Hearings, transcript, 1/14/85, Richard C. Barker, p. 137, referred to a possibly adverse vote "where our chairman was solicited by the chairman of a company because he had learned...that we planned to vote against a package of anti-takeover resolutions."

[48] Hearings, 1/10/85, written statement of Alvin D. Lurie, p. 6.

[49] Hearings, 1/10/85, written statement by Frank Cummings, p. 3. (Cf. Donovan v. Bierwirth, 680 F. 2d 263, 271 (2d Cir. 1982) (suggesting that corporate officers who are also trustees of a plan may need to resign for the duration of a tender offer in order to avoid conflicts of interest)).

fiduciary duties as between corporate shareholders and fund beneficiaries. For example, former SEC Commissioner Bevis Longstreth was quoted to the effect that "...buyouts tend to put managements in the position of acting as both buyer and seller, and no fairness opinion, review by outside directors, or state or federal law can assure that public shareholders will be treated fairly" (emphasis added).[50/] There has been no reconciliation of the policies that on one hand encourage retirement benefits independent of the future success of the company, and, on the other, profit sharing funds whose entire reason for being is to give participants "a share of the corporate gamble."[51/] The Hearings did not focus on resolution of this specific problem; it is one of several side effects of the fact that a major portion of the nation's investment pool is held in a fiduciary capacity. There is the need to develop new institutions that can analyze these problems and formulate solutions.

In addition to the problems that delegation creates, recent developments have renewed focus on the exact extent of a trustee's responsibility to vote the shares of portfolio investments. Institutional investments generally, and ERISA

[50/] James E. Heard, *op. cit.*, p. 4.

[51/] Frank Cummings, *op. cit.*, p. 6.

plans specifically, continue to increase dramatically as a percentage of the total investments outstanding in the country. Projections are that ERISA plans will hold more than half of all the equity securities in the United States before the turn of the century. Perhaps not entirely by coincidence, take-over fever reached epidemic proportions in 1984. The causality may arise from the widespread conviction that fund managers and other fiduciaries are obligated to tender their shares to the highest cash bidder.[52/] The size of ERISA holdings cannot be ignored since the "institutions" are the indispensible participants in a successful take-over. Nor can the fact that their vote has value be ignored, because it is just this vote that has pivotal significance to a potential acquirer.

To appreciate the importance of institutions exercising their franchise, consider the situation if they do not act. Power is then conferred on other elements in the corporate

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[52/] Peter F. Drucker published a widely read editorial in the Wall Street Journal to this effect in November 1984. Peter Vermilye comments: "We share with Peter Drucker the concern that the take-over mania has gone too far. It has gone beyond the desirable objectives of reallocating capital to more productive uses. It is at times counterproductive to buy out major companies at huge premiums with borrowed funds. We agree with [the Administrator of the Office of Pension and Welfare Benefit Programs] that it is not always in the best long term interest of stockholders to sell out well managed companies."Peter Vermilye, op. cit., p. 3.

power balance far beyond that which is appropriate. Thus, managements and small active shareholders have in effect been "given" control over corporations by institutions refusing to be inconvenienced by exercising unwanted rights. "But they cannot avoid exercising that power, either directly or by default. They have the votes and if they don't do it, someone else would do it. It is the classical dilemma..."[53/]

Professor Joseph Auerbach agonized over this problem by hueing precisely to the trustee's sole responsibility to his beneficiary. While elaborating on the requirement of trustee supervision of portfolio companies, he recommended against transitive activity by the trustee on the grounds that it would inevitably distract from the trustee's duty to preserve trust assets. "I don't know how to be both an owner-manager and a fiduciary-trustee for people's benefits. I don't know how to do it. I can't ever find myself able to be wholly objective... Am I now -- now that I am controlling the corporation -- am I now making this decision for the benefit of the beneficiaries? Am I making it for my benefit? Am I making it for the benefit of the community?...and the only way that I know...of facing up to this problem is to say I only

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[53/] Professor Robert Soldofsky, op. cit., p. 25.

have one master. I only have one function."[54] This probably is as near as we'll get to a definitive statement of the weighing of the different aspects of the trustee's obligation to his beneficiary. It leaves unanswered the obverse part of the problem: while the trustee's pristinity is preserved, who will take responsibility for the adverse effect on trust holdings? Possibly, in Auerbach's Ockham-like analysis is the birth of the notion of a yet undefined institution to exercise franchise power for trust holdings. If the trustee cannot do it, and if it must be done in order to preserve the value of trust assets, then some formal process must be devised to effect the desired goal.

Although a detailed consideration was well beyond the scope of these Hearings, witnesses described new institutions that intended to consider more active exercise of their rights. Jesse Unruh, State Treasurer of California, described the formation of a group of public funds to consider areas of mutual interest with respect to their rights in portfolio investments.[55] Public funds are largely immune from the potential conflicts of interest and other restraints that temper whatever activist instincts exist among ERISA managers.[56] It should be noted that in the past, political pressures have been brought to bear on state officials having voting powers, and that the provisions of ERISA do not apply to public plans.

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[54] Hearings, transcript, 1/10/85, Professor Joseph Auerbach, pp. 211, 212.
Peter Vermilye, op. cit., p. 51.
Professor Roger Murray, op. cit., p. 82. "The institutional investor is not investing in order to ...direct the internal affairs of the corporate entity."

The nature and limits of fiduciary obligation were spelled out by Professor Auerbach, and they illustrate why new guidelines for action are needed. On the one hand, he wrote, "Shareholders must protect themselves...against erosion of protective charter provisions"; on the other, he counselled that a "Fiduciary must remain unencumbered...[neither] control [n]or participation in new management...is an appropriate objective."[57] Auerbach conceives of a fiduciary model in which the fiduciary is solely concerned with preservation of the value of the trust asset and does not permit his attention to be diverted by such peripheral issues as conducting a law suit, planning to acquire control, or participating in running the company. This model requires uncompromising attention to and protection of the full franchise rights to which stock ownership entitles the trust.

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[55] Hearings, 1/15/85, written statement by Jessie Unruh, p. 2.

[56] James E. Heard, op. cit., p. 9.

[57] Professor Joseph Auerbach, op. cit., pp. 3, 5.

Hugh Calkins testified that, "Directors who consider that their fiduciary obligation runs to the owners of a stake in corporate America will take a different view of some questions than directors who consider that their obligation runs to a fluid group of short-term speculators in the shares of a single corporation. The broader view may not be sounder, but it should be given more consideration than under present practice..."[58] The ERISA fiduciary is literally a universal shareholder. Typically, he will own shares in all the companies that are parties to a complex transaction. "Institutional investors who own interests in the buyer, the seller, the supplier, and the customer have a different view of such major transactions than a holder of shares in only one of the participants."[59] Many legal and operational questions need to be addressed. No one really knows the extent to which it is appropriate for fiduciaries to consult with each other, but it is clear that the process must begin.

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[58] Hearings, 1/10/85, written statement by Hugh Calkins, p. 20.

[59] Ibid, p. 19.

OPWBP Hearings - Conclusions

This summary earlier noted the concept of separating franchise from economic rights in shares of stock. For reasons mentioned above, substantial testimony indicated that it would seem preferable for the plan sponsors to retain the voting rights. "Direction, if any, must come from the plan sponsor and it will eliminate the manager's conflict of interest problem."[60] In addition to Dean LeBaron's imaginative reference to selling voting rights to the highest bidders, two specific proposals were made in the course of the Hearings as to how the sponsor might exercise his franchise responsibilities. Neither idea is new. Professor Soldofsky first publicly proposed "structured differentiation" in the early seventies. "...I see that there would be great merit in separating the vote and control because then you could set up an important organization which would represent all interests in the society, the institutions, the individual shareholders, the state and local pension funds."[61] Soldofsky envisages an institution along the lines of the Federal Reserve, that would have public and private directors. Professor Murray draws on his long experience as an "outside" mutual fund director and principal in TIAA/CREF to suggest that the sponsors' Board of Directors "...recruit a panel of knowledgeable and independent individuals to provide advice on the policies to be established. This Advisory Panel on Corporate Governance Issues could have a Secretary drawn from the staff to gather information from portfolio companies and investment managers."[62]

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[60] Professor Roger Murray, op. cit., p. 2.

[61] Professor Robert M. Soldofsky, op. cit., p. 29.

While this testimony does not converge on a single recommendation regarding the exact form a new institution might take, it was clear that many witnesses thought such an entity would be desirable.

VII. Summary

As is evident, the testimony covered a broad range of topics and viewpoints. There was consensus, however, on the importance of several concerns:

A. Cost-Benefit

It was noted above that the annual cost of ERISA in foregone revenue is 43.2 billion dollars. There are two obstacles to measuring the Act's benefits. One is the absence of timely and complete plan data given the current paper-based filing system for annual reports (Form 5500 reports). In 1984, OPWBP conducted a highly successful pilot project that tested the electronic submission of ERISA data (e.g., by computer tape or diskette). The transition to an electronic system is crucial if timely data on ERISA plans and their assets is ever to be available to public and private sector analysts and decisionmakers. Without such data, there is no practical way to compare benefits to costs.

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[62] Professor Roger Murray, op. cit., p. 4.

The second obstacle is the absence of retirement income security policy that focuses on accomplishment of measurable objectives. ERISA simply encourages "activity" -- the activity engendered by successive delegating, by hiring managers, consultants and experts, by boosting service providers' fees with no eye to their value to plan beneficiaries. None of this activity necessarily promotes the social policy objectives implied by a law that promotes and protects retirement income.

B. Voting Responsibilities

As testimony made clear, the question of corporate governance is growing in importance as the size of ERISA assets grows. Multi-layered delegation of responsibility not only dilutes the sponsor's perception of his duties, but obviously increases the potential for major conflicts of interest among the delegatees. Recent take-over activity has further illuminated the potential for mischief in cases where votes are solicited for defensive measures. While the Hearings yielded only anecdotal material regarding pressure brought to bear on money managers, it served as evidence of the conflicting loyalties that can influence fiduciary behavior.

As one witness noted, the interests of those who manage ERISA funds are not the same as the interests of the beneficiaries; in the end, it is the plan sponsor who is responsible for protecting the beneficiaries' assets, one of which is the right to vote. The sponsor, by process of elimination, emerges as the one party in the ERISA system who is least encumbered to exercise that right consistently and thoughtfully. There was nearly unanimous agreement in the Hearings that plan sponsors must assume a more proprietary role in voting plan shares. Further, there was interest shown in exploring new institutions that might be used to insulate the voting function from conflicts of interest.

C. ERISA Data Management

As mentioned above in (A), the establishment of a computerized data base for ERISA annual reports is vital to informed decisionmaking. All the issues discussed in the Hearings turn on information; if ERISA is to be evaluated as a major component of public policy regarding retirement income, the agencies that administer it must have access to current plan statistics.

D. Performance Measurement

Witnesses were surprisingly candid in their comments that a) to the extent they exist, performance data are used merely as a marketing tool, not as objective indicators; and b) that competitive market forces will always discourage the establishment of uniform objective performance standards. Surprisingly, the feeling was that in this instance, the Federal Government is uniquely positioned to assist in establishing such standards. DOL was urged to act as a convenor in starting the process of standard-setting.

E. Fiduciaries' Exercise of Voting Rights

There appears to be uniform public confusion about the Department's view of the extent to which ERISA permits the pass-through of voting rights to participants in plans that hold employer stock. This question has become particularly significant given the widespread popularity of ESOPs, and other stock ownership plans, and their pivotal nature in determining the outcome of tender offers and other corporate machinations. The Department should consider promulgating regulations that define the scope of a plan fiduciary's responsibility to exercise the voting rights of employer securities held in ERISA plans, even in situations where the plan purports to pass through the voting power to participants. These regulations would necessarily include an interpretation of Section 404(c) of ERISA as well as Section 403(a).

F. Self-Regulatory Organization(s)

The essential nature of the ERISA statute is cooperative, not adversarial. The very fact of their willingness to testify augmented many witnesses' statements that common, thorough understanding of the law is a worthwhile objective. The Department was applauded for holding an open discussion of fund performance and corporate governance, and it was clear that witnesses saw the Hearings as a joint contribution to improved understanding of the issues.[63]

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[63] Hearings, transcript, 1/9/85, Theodore M. Theodore, p. 131. Mr. Theodore expressed concern over whether "...Labor [is] trying to protect pensioners from Wall Street." The Administrator assured him personally and for the Department that the purpose of the Hearings was informational and the policy of the Department was to develop private sector mechanisms rather than to expand government's role.

OPWBP Hearings - Conclusions

There is no precedent for the massive investment network that ERISA covers, nor for the rate at which financial markets become increasingly sophisticated and complex. The need for ERISA constituents to respond to these dynamics has grown commensurately. It is DOL's aim to help meet this need cooperatively, not in an obstructionist manner. It is evident that an enhanced partnership of public-private sector experts can assist in this effort.

One model for such a partnership, which was discussed in the Hearings,[64/] is a self-regulatory organization (SRO). The Department has spent a great deal of time researching this concept, and studying other SROs (the

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[64/] Hearings, transcript, 1/9/85, Sophie Korczyk, p. 172: "Exemptions, as we know, can take many years to process... Private sector input in this process could expedite the...exemptions, as an SRO could draw directly on experts in the affected industry to determine the validity of a specific request...

"At the same time, if such an organization were modeled on existing organizations, like the Financial Accounting Standards Board and the National Association of Securities Dealers, the organization would not be able to approve all applications indiscriminately, as the Department would retain final jurisdiction..."

See also the exchange between Ms. Korczyk and DOL Solicitor Francis Lilly, ibid, pp. 180-181.

Solicitor Lilly: "Do you think that the pension industry would use [an SRO]?"

Ms. Korczyk: "...I would tend to guess yes...The Financial Accounting Standards Board is certainly feared every bit as much as the IRS or any other arm of government, and so I think it would be used."

National Association of Securities Dealers and Financial Accounting Standards Board). There are many possible roles for such an organization; it could assist in the ERISA prohibited transaction exemption process, and conceivably serve as a forum for the discussion of key issues such as those addressed in the Hearings. It might also convene parties to deliberations like the performance measurement standard sought by witnesses. DOL should be receptive to initiatives by the private sector to explore the creation of an SRO.

DEPARTMENT OF LABOR

Office of Pension and Welfare Benefit Programs

Participation of Self-Regulatory Organizations in the Prohibited Transaction Exemption Process—Solicitation of Comments

AGENCY: Office of Pension and Welfare Benefit Programs, Labor.

ACTION: Solicitation of comments.

SUMMARY: This document requests comments from interested members of the public on the feasibility of participation by self-regulatory organizations in developing exemptions from the prohibited transaction rules of ERISA. The existing prohibited transaction exemption process has been criticized, and the Department anticipates that the public comments received in response to this notice will assist it in studying more efficient ways of handling prohibited transaction exemption requests.

DATE: Comments should be submitted on or before February 8, 1985.

ADDRESS: Comments (preferably 3 copies) should be submitted to the Office of the Administrator, Office of Pension and Welfare Benefit Programs, Room S4516, U.S. Department of Labor, Washington, D.C. 20210, Attention: "SRO Inquiry."

FOR FURTHER INFORMATION CONTACT: Janet Brown (202)523–8952.

SUPPLEMENTARY INFORMATION: The Department of Labor (the Department) is responsible for administering the fiduciary responsibility provisions of the Employee Retirement Income Security Act of 1974 (ERISA). [1] Section 406 of ERISA prohibits certain transactions between a plan and a "party in interest" and section 4975 of the Internal Revenue Code (the Code) imposes an excise tax with respect to prohibited transactions between a plan and a "disqualified person" (defined, with certain minor exceptions, in the same manner as the term "party in interest").

Section 408(a) of ERISA and Section 4975(c)(2) of the Code provide that the Secretary of Labor and the Secretary of the Treasury, respectively, may grant administrative exemptions from the prohibited transaction provisions of ERISA, provided certain conditions are met. The Secretary of the Treasury's authority to issue such exemptions was transferred to the Secretary of Labor in 1978; since that time prohibited transaction exemptions have been issued solely by the Department of Labor.[2]

The Department is exploring methods of enhancing the prohibited transaction exemption process, particularly as it relates to complex financial transactions. One method under consideration is whether the private sector might be more involved in the exemption process. Thus, the Department is soliciting comments from interested persons with respect to this concept.

Background

A. Statutory Provisions

Under Section 408(a) of ERISA,[3] the Department may (with certain limited exceptions) grant conditional or unconditional exemptions from all or part of the prohibited transaction restrictions of the Act. Before granting such an exemption, however, the Department must find that the exemption is: (1) Administratively feasible, (2) in the interests of the plan and of its participants and beneficiaries, and (3) protective of the rights of participants and beneficiaires.

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[1] 29 U.S.C. 1001, et seq.

[2] Reorganization Plan Number 4 of 1978 (43 FR 47713, October 17, 1978), effective December 31, 1978 (44 FR 1065, January 2, 1979).

[3] Except where the context clearly requires otherwise references in this notice to the various provisions of Title I of ERISA should also be read to refer to the corresponding provisions of the Code.

Section 408(a) also establishes certain procedural requirements for administrative exemptions from the prohibited transaction rules. The Act requires that the Department establish an exemption procedure and that exemptions may only be granted pursuant to that procedure. In addition, the Department must publish notice of a proposed exemption in the Federal Register and must assure that adequate notice of the pendency of the exemption is given to interested persons. The Department must also interested persons to present views. In the case of an exemption from the restrictions of fiduciary self-dealing in Section 406(b) of ERISA, the Department may not grant the exemption unless it affords an opportunity for a hearing and makes a determination on the record with respect to the three findings required by the Act.

B. The Exemption Process

The Department administers the prohibited transaction exemption program pursuant to the ERISA Exemption Procedure[4] (ERISA Procedure 75–1). Under the procedure, any party in interest (or disqualified person) with respect to a plan who is or may be a party to a prohibited transaction may initiate an exemption proceeding by filing an exemption application with the Department. In addition, any party in interest or any association or organization representing parties in interest may initiate a class exemption proceeding by filing an exemption application. The Department may also propose exemptions on its own motion.

An exemption application must include detailed information regarding the plans involved, applicant or applicants, and the transactions for which relief is requested. This information includes a detailed description of the fiduciaries and parties in interest who would be involved in the transactions, a statement whether the transactions are customary in the industry involved and a description of the hardship or economic loss which would result if the exemption application is denied. Further, the application must contain a statement explaining why the exemption would be consistent with three statutory findings that the Department must make in order to grant it.

An exemption application must also disclose information regarding the previous activities of the applicant and the plan or plans involved. For example, the applicant must indicate whether it has ever been found to have engaged in a prohibited transaction or whether it or any other party in interest who would be involved in the transaction is, or in the last five years has been, a defendant in any lawsuit concerning such person's conduct as a fiduciary or party in interest.

Upon receipt, an application for an individual exemption is given an identification number and is assigned to an employee benefits specialist in the Division of Exemptions of the Office of Pension and Welfare Benefit Programs. The analyst reviews the application and, if necessary, requests additional information from the applicant.

After the exemption application and any additional material submitted by the applicant are reviewed, a decision generally is made either to propose the exemption or to issue a tentative denial letter.[5] A tentative denial letter states that the Department has tentatively decided not to propose the exemption and contains a brief statement of the Department's reasons for the determination.

The ERISA exemption procedure also provides that an applicant may request a conference as of right in the event the Department contemplates denying the exemption request. Thus, a tentative denial letter will also contain an offer to hold such a conference. Exemption conferences are held between the applicant (or the applicant's representative) and employees of the Department and consist of an informal exchange of views regarding the issues raised by the exemption application.

If, after consideration of any material submitted by the applicant in response to the tentative denial letter (and any material submitted, or arguments advanced at the conference), the Department determines that the application for exemption should still be denied, it will issue a final denial letter informing the applicant of its action and providing a brief statement of reasons.

If the Department tentatively decides that an exemption application should be granted, it will publish a notice of pendency of the exemption (notice of proposed exemption) in the Federal Register. This notice contains a summary of the representations made by the applicant in the exemption application and a statement of the exemptive relief which the Department proposes to grant. In addition, the proposed exemption requests comments from interested persons within a stated period of time (usually 40 days). In the case of a proposed exemption that would provide relief from any of the restrictions on fiduciary conduct in Section 406(b) of ERISA, the proposed exemption also indicates that any interested person may request a hearing with respect to the proposed exemption.

The applicant for a proposed exemption must also assure the Department that notice of the pendency of the exemption is given to interested persons. The nature and extent of such notice varies depending upon the nature of the proposed exemption and the plan or plans involved.

After the proposed exemption has been published and the comment period has expired, the Department will consider any comments submitted; in the case of a Section 406(b) exemption, it will conduct a hearing if one is requested. On the basis of the record thus developed (including the application, any additional submissions of the applicant, any written comments from interested persons, and the testimony at any hearing on the exemption), the Department will make a final decision with respect to the proposed exemption. If the proposed exemption is granted, a notice to that effect is published in the Federal Register. If the Department determines not to grant the proposed exemption, it publishes a notice withdrawing the proposal and issues a final denial letter to the applicant.

The Department's actual experience has been that it receives no comments on the vast majority of proposed exemptions and that most proposed exemptions are granted as a matter of course after expiration of the comment period. The Department retains the authority, however, to independently decide to deny an exemption that has been proposed.

Applications for class exemptions are treated in a manner similar to applications for individual exemptions, but with some modifications. First, trade groups representing classes of persons who encounter similar prohibited transaction issues are typically actively involved in the class exemption process. Second, since class exemptions by their nature relate to a variety of transactions the specific characteristics of which have not been reviewed by the

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[4] 40 FR 18471, April 28, 1975.

[5] If review of the exemption application indicates that the transaction is either not a prohibited transaction under ERISA or is an exempt transaction under an existing statutory or administrative exemption, the Department will issue an "interpretive response" calling attention to the relevant authorities and indicating that, if the Department receives no further submission from the applicant within 30 days (explaining why further relief is necessary), the application file will be closed without further action.

Department, they typically contain detailed conditions that are intended to assure that the exemption will be consistent with the statutory standards. Third, since class exemptions affect a large number of parties in interest, many of whom have a substantial interest in the exemption proceeding but who have not been parties to the application, comments received in response to a notice of proposed exemption often play an important role in the process of developing a final exemption. In this respect, the Department has frequently conducted informal hearings regarding proposed class exemptions in order to assure that the views of all affected persons are taken into account.

Possible Involvement of Private Sector Oranizations in the Exemption Process

A. Involvement of Private Sector Groups Under the Existing Procedures

The legislative history of ERISA indicates that Congress intended that the Department administer the prohibited transaction exemption program so as not to disrupt unnecessarily the established business practices of financial institutions that provide fiduciary services to employee benefit plans.[6] Accordingly, private sector involvement in the prohibited transaction exemption process is both appropriate and necessary in order to carry out Congressional intent. Industry groups now play a relatively significant role in the development of class exemptions from the prohibited transaction rules, but have little, if any, role in the individual exemption process.

Industry group submissions have often served as a valuable resource in identifying areas where relief from the prohibited transaction rules is needed. The utility of trade group submissions to the Department is limited, however, in two main ways. First, such submissions often focus on the affected industry's need for relief from the prohibited transaction rules rather then an analysis of the ways in which the Department can fashion exemptive relief that is consistent with the statutory factors that must be satisfied before an exemption may be granted. Second, industry submissions often involve sophisticated financial transactions, but do not present the factual material in the way that is most useful to the Department's staff in making a decision.[7]

In the Department's view, more effective use of private sector resources in dealing with prohibited transaction exemption applications—those seeking individual relief as well as those seeking class relief—could expedite the exemption process and could result in exemptions that will relieve unnecessary burdens on parties in interest and will be consistent with the Department's statutory obligations. Thus, the Department is exploring ways in which this increased private sector involvement can be achieved, one of which might be the participation of a self-regulatory organization.

B. Self-Regulatory Models in the Securities Industry.

One area in which self-regulatory organizations play a very significant role is in the administration of the federal securities laws. The Securities and Exchange Commission (the Commission) is the agency charged by Congress with administering those laws. In discharging its duties, however, the Commission makes use of a variety of private sector self-regulatory organizations (SRO's). These organizations perform some rulemaking, investigatory and enforcement functions for, and under the direction of, the Commission. The functions of these organizations are not completely analogous to the functions that a self-regulatory organization might perform under ERISA, but the Department beleives their existence illustrates how private entities may play an important role in a federal regulatory program.

1. *Securities Industry Regulation.* Section 15A of the Securities Exchange Act of 1934 provides for the creation and registration of SRO's to establish and promote ethical and standardized principles of trade in the securities business.[8] Registration by SRO's with the Commission is permitted only if the Commission determines that such an association is organzied so as to be able to comply with the Commission's rules and regulations as well as to enforce compliance among its members. Procedurally, the rules of an association must ensure that directors are representative of the differing interests in the financial community; substantively, an association's rules must be designed to "prevent fraudulent and manipulative practices, to promote just and equitable principles of trade * * * [to facilitate] transactions in securities * * * and in general, to protect investors and the public interest."[9]

Section 19 of the 1934 Act outlines the Commission's oversight responsibilities and powers regarding self-regulatory organizations. Registration of an exchange or SRO is subject to public notice and comment procedues and the substantive statutory requirements outlined in Section 15A. The Commission may grant or deny applications for registration; it also may cancel registration of an SRO if it finds that it has ceased to perform in the manner for which it was granted registration.[10]

Rules and regulations proposed by an SRO must be submitted to the Commission for review, with an opportunity for public notice and comment.[11] The Commission retains the authority to amend all rules of an SRO and it may even "summarily abrogate" them if it finds such action necessary in the public interest.[12]

The National Association of Securities Dealers, Inc. (NASD) is the one organization registered with the Commission under Section 15A of the 1934 Act. NASD is principally charged with promulgating, maintaining and enforcing a code of business ethics among over-the-counter brokers and dealers.[13] While membership in NASD is voluntary, almost all brokers and dealers are members and thus subject to its investigatory and disciplinary powers.[14] Members are generally forbidden from conducting business with non-members which both encourages membership and facilitates peer review.

NASD's membership is divided into 13 districts whose members elect some of the members of NASD's Board of Directors; other seats in the Board are reserved for representatives of industry and the professions. As of 1983, there were 296,000 registered representatives of the investment and securities industry, and 4685 member firms. Membership may be defnied to or withdrawn from anyone suspended from a registered exchange or anyone convicted of a misdemeanor or felony involving such offenses as embezzlement, misuse of funds, or abuse of a fiduciary relationship among others.

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[6] H.R. Rep. No. 1280, 93d Cong., 2d Sess. [illegible] (1974).

[7] For example, an industry association's submissions often contain very general statements of fact, but do not discuss differences between its various members' business practices. In addition, the submissions often include voluminous background material, but do not include a sufficient summary of the contents of the background material or a meaningful explanation of its significance.

[8] Securities Exchange Act of 1934, *as amended,* Section 15A; 52 Stat. 1070 (1938); 15 U.S.C. Section 780-3 (1982), hereafter "1934 Act."

[9] 1934 Act, Section 15A(b)(2), (4), (6)

[10] 1934 Act, Section 19 (a) (1).

[11] 1934 Act, Section 19 (b) (1).

[12] 1934 Act, Section 19 (b) (3) (c).

[13] SEC, "The Work of the SEC," 13 (February 1984).

[14] NASD, "An Introduction to NASD," 15 (1984).

NASD's staff is comprised of three divisions: Legal and Compliance; Member and Market Services, and Automation. Within each division are various departments charged with developing and admistering regulations and services for different segments of the securities industry. The Legal and Compliance Division has promulgated a Uniform Practice Code as well as rules of Fair Practice, both of which are submitted for approval to the SEC and which are the standards against which securities transactions conduct is generally judged. occasionally, NASD has adopted rules in lieu of regulation proposed or threatened by the SEC, such as its rules regarding "free riding" and "withholding".[15]

NASD staff at the district level conducts annual examinations of members' books and records; it is from this review that complaints against members typically arise.[16] These audits, conducted on an unannounced basis, examine members' books to check compliance with association rules. At the same time, NASD staff monitors compliance with the SEC's Net Capital Rule and the Federal Reserve Board's Regulation T.[17]

Member firms or individual violators of NASD standards are subject to sanctions imposed by NASD which range from censure, to fines, to expulsion. NASD has internal review procedures in place under which members may challenge a disciplinary decision; appeal is also available to the Commission and ultimately, to the courts. Only very rarely, however, has this external appellate procedure been invoked. Notice of expulsion of a member is released to the press, although lesser penalties may be kept confidential by the SEC.

NASD provides a range of services to its members. In addition to maintaining an over-the-counter quotation service, NASD has an Information Department which publishes newsletters, press releases and various educational booklets. These publications complement enforcement activities and serve as a form of preventive regulation. In addition, the Association conducts seminars and conferences to inform members of current issues as well as to solicit member views on matters affecting them.[18]

NASD's activities and reputation have allowed the Federal government to limit its involvement and expenditures in monitoring the activities of the securities industry. However, the fact that the Commission may increase its involvement in the regulation of the securities industry at any time, undoubtedly strengthens the industry's commitment to meaningful self-regulation.

2. *Financial Accounting Standards.* Another private sector organization upon which the Commission relies to aid it in discharging its statutory responsibilities is the Financial Accounting Standards Board (FASB). The legislation creating the Commission gave it the authority to develop and promulgate accounting standards to assure proper compliance with the financial disclosure provisions of that Act.[19] The Commission also has authority to prescribe accounting standards and procedures for compliance with the other three major acts which it administers.[20]

Historically, however, the Commission felt that reliance on accounting principles established by practitioners in the private sector was preferable to promulgating standards of its own. Thus, the Commission has chosen to maintain an oversight role toward the accounting profession. The Commission's first chief accountant stated as early as 1937 that the policy of the Commission was "to encourage * * * accountants to develop uniformity of procedure themselves * * * and to step in directly only as a last resort."[21]

More recently, the Commission reaffirmed its commitment to rely generally on private sector initiative in formulating financial accounting standards. A group established by the American Institute of Certified Public Accountants (AICPA) and chaired by former SEC Commissioner Francis M. Wheat conducted a study of the accounting standards area and recommended that a private sector organization would be most capable of setting standards for the accounting profession. As a result of this recommendation, the Financial Accounting Standards Board was established in 1973. In its Accounting Series Release 150, the Commission announced that it intended to look at accounting principles established by FASB in administering the federal securities laws. Recognizing that private sector resources and expertise exceeded its own, the SEC stated that it endorsed the establishment of the Board because it provided "an institutional framework which will permit prompt and responsible actions flowing from research and consideration of varying viewpoints."

FASB's standard-setting process is conducted under formal rules of procedure similar to the Commission's own, which invite and consider broad-based public comment.[22] With regard to research and policy development, FASB also makes public its proposals and solicits suggestions and criticisms. Ultimately, it is the Commission's responsibility to ensure that adequate disclosure is made in the financial statements filed under federal securities laws. In order to fulfill this responsibility, the Commission maintains an active and ongoing oversight role of FASB. As with the NASD, the Commission has reserved the authority to establish its own rules of accounting if private sector initiative is not satisfactory. Thus far, however, the Commission has not seen the need to do so.[23] Of eighty standards promulgated by FASB since its inception, the Commission has expressed formal disagreement only once. The Commission and FASB maintain a close working relationship to alert each other to perceived issues and potential problems in the industry. Their relationship has been described as one of "mutual non-surprise."[24]

FASB performs no major enforcement activities. Rather, compliance is compelled by the Commission as part of its general enforcement program. Where an accountant has seriously departed from professional principles, the Commission may institute disciplinary proceedings under its Rule of Practice 2(e).[25] Accountants may be barred from further practice before the Commission or may be permitted to practice only under certain conditions.

The Board has seven members who are elected by its sponsoring organization, the Financial Accounting

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[15] See generally, Mark White, *The National Association of Securities Dealers, Inc.*, 28 Geo. Wash. L.Rev 230, 280 (1959).

[16] The public as well as othe NASD members may also initiate a complaint.

[17] *See*, SEC Net Capital Rule at 17 CFR 240.15c-3-1; Federal Reserve Board Regulation T at 12 CFR 220.1–220.8.

[18] *Id.* at 13.

[19] SEA of 1934 section 12(b), 15 U.S.C. section 78l(b).

[20] The Securities Act of 1933, section 7, 15 U.S.C. 77g and Schedule A; The Public Utility Holding Act of 1940, section 5(b), 15 U.S.C. 79b, 79d and 79e; The Investment Company Act of 1940, section 8b, 15 U.S.C. 80a-8(b).

[21] Carman G. Blough, Comments in a Round Table on "Developments in Accounting Theory and Practice Since 1929," *American Institute of Accountants, 50th Anniversary Celebration* at 190 (1937).

[22] FASB, "Facts About FASB," Relationships with the Federal Government," at 1–4 (1984).

[23] *See* generally, SEC Report to Congress, "The Accounting Profession and the Commission's Oversight Role," (July 1, 1978).

[24] FASB, "Facts About FASB: 1 (1984).

[25] SEC Rules of Practice are codified at 17 CFR 201.1 *et. seq.*

Foundation (FAF), for five-year terms. The Board employs a professional staff of approximately 45 people, most of whom are accountants. It also sponsors an advisory committee whose members are recognized experts in the field. The FAF receives contributions from the financial and accounting communities to support FASB, but recently, half of FASB's operating expenses have been met by the sale of publications.[56]

The Commission's reliance on FASB as a standard-setting organization has been subject to some criticism,[57] but a United States District Court upheld the Commission's reliance on FASB when it was challenged as an impermissible delegation.[58]

The use of self-regulatory organizations by the Commission implements a conscious Congressional policy. In passing Sections 15A and 19 of the 1934 Act, Congress decided that it was preferable for industry to have the opportunity to regulate itself rather than to have direct substantive intervention by the Commission. Congress thereby avoided what would have been large increases in the size of the Commission's staff and the attendant increases in public expenditures. At the same time Congress provided for, and the Commission has retained, authority for direct and swift federal intervention if the need arises.[59]

C. Issues Pertaining to the Possible Role of an SRO in the ERISA Exemption Process

In its examination of alternative ways to handle exemption requests, the Department maintains as its primary goal the protection of the interests of participants and beneficiaries who are covered by plans subject to ERISA. Thus, any proposal to enhance the role of private organizations in the prohibited transaction exemption process must assure the Department's ability to diligently fulfill this obligation.

1. *Limitations on the Use of Self-Regulatory Organizations.* ERISA allows the Department to propose and grant exemptions from the prohibited transaction provisions of the Act only after it makes certain substantive findings and adheres to certain stated procedures. In the Department's view, any procedure under which a self-regulatory organization participates in the exemption process must preserve the Department's authority to make an independent determination both with respect to the decision to propose an exemption and with respect to its decision to grant an exemption that has been proposed. In addition, any such procedure must assure that notice of pendency of the exemption be published in the **Federal Register**, that adequate notice be given to interested persons, and that an opportunity for a hearing be provided in appropriate cases.

2. *Fundamental Characteristics of Self-Regulatory Organizations.* In the Department's view, a self-regulatory organization must have certain fundamental characteristics in order to play a meaningful role in the prohibited transaction exemption process:

(i) *Independence.* The existing self-regulatory bodies discussed above have a high degree of independence. In the case of the NASD, specific provisions of the federal securities laws assure this institutional independence; in the case of FASB, the organizing professional and business groups have taken steps to assure institutional as well as financial independence. As to the latter, the Financial Accounting Foundation, a not-for-profit entity, receives contributions from the accounting community to fund FASB, but the Foundation stands between that community and the Board. The Department expects that any self-regulatory organization that might be formed to participate in the ERISA exemptions process would be similarly independent.

(ii) *Expertise.* A self-regulatory organization must possess a high degree of expertise in order to function effectively. Thus, the sponsors of such an organization must be prepared to provide resources adequate for the organization to develop a staff that has sufficient technical expertise for the organization to discharge its responsibilities. The Department believes that such expertise could be extremely valuable to its own exemptions staff in analyzing complex financial matters, and could thereby benefit all parties concerned.

(iii) *Continuity.* A self-regulatory organization should be a permanent body that performs services for its members in addition to having input in the exemptions process.

(iv) *Funding.* The Department anticipates that the treatment of expenses associated with membership in an SRO or the processing of exemption applications by such an organization would be assumed by its membership. In this respect, the costs of funding an SRO would not be dissimilar to the costs associated with applying for a prohibited transaction exemption under the Department's existing procedures.

3. *Potential Functions of an ERISA Self-Regulatory Organization.* There appear to be at least three broad roles that a self-regulatory organization might perform under ERISA.

First, a self-regulatory organization could provide a source of expertise in the exemption process. Although access to such expertise would be helpful with respect to a variety of different kinds of exemption applications, it would be particularly useful in the case of sophisticated financial transactions involving large institutions. The staff of a self-regulatory organization could analyze specific exemption proposals and make recommendations based on their evaluation in the context of the specific statutory factors for granting an exemption. Their analyses and recommendations could be made available to the Department or to an advisory body. The self-regulatory organization and the Department could also cooperate in developing guidelines which would assure that the analyses and evaluations submitted by the self-regulatory organization are of maximum use, in form and content, to assist the Department in making a prompt determination. If the structure of the self-regulatory organization were such that the Department could be assured that the evaluations and analyses were disinterested and of consistently high quality, the Department could find it in the best interest of all parties to process the exemptions on an expedited basis. Ultimately, the goal of this process would be that the Department could make a decision on such exemption applications within a stated period of time.

A second function that an SRO might perform is to serve as an informed source of expertise for aiding the Department in developing class exemptions from the prohibited transaction provisions of ERISA. The concept of an agency negotiating with representatives of constituent groups for the purpose of developing regulations has been tested by other federal agencies and has met with some success.[60] The procedure of "regulatory negotiation," in the words of the Administrative Conference recommendation:[61]

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[56] FASB's operating expenses for calendar year 1983 were $8,448,000.

[57] *The Accounting Establishment, A Staff Study,* S. Doc. 95-34, 95th Cong., 1st Sess. (1977).

[58] *Arthur Andersen & Co. v. S.E.C.,* No. 76-C-3832, unpublished op. (N.D. Ill. Sept. 5, 1978).

[59] *See* S. Rep. No. 1455 at 3-4 and H.R. Rep. No. 2307 at 4-5, 75th Cong., 3d Sess. (1938).

[60] *See* FAA and EPA notices of intent to establish regulatory negotiation advisory committees at 48 FR 21339 (1983), 48 FR 7494 (1983), and 49 FR 17576 (1984). *See also* favorable review of FAA negotiations at 31 Fed. Bar News and Journal 371 (Nov. 1984).

[61] A.C.U.S. Rec. 82-4, 1 CFR 305.82-4 (1984).

> enables the interested parties to identify the major issues, gauge their importance to the respective parties, identify the information and data necessary to resolve the issues, and develop a rule that is acceptable to the respective interests, all within the contours of the substantive statute.

The Department believes that private organizations may be able to perform an important role in developing class exemptions through the use of a "negotiation" technique similar to that described above. Participation by an SRO in such a process would appear to have particular potential because the SRO would, over time, develop a high degree of expertise in dealing with issues arising under the prohibited transactions of ERISA.

A third possible role for a self-regulatory organization might arise if such an organization possessed a very high degree of independence from its supporting membership, if its membership adhered to high standards of conduct developed by the organization and if the self-regulatory organization could compel adherence to those standards by imposing meaningful disciplinary actions. In such circumstances, the Department might be able to fashion a class exemption under which relief would be conditioned (in whole or part) on membership in the self-regulatory organization. A self-regulatory organization would need to be very well-established in order to play such a role, however, and the Department and the public would need to have a high degree of confidence in the organization in order to make the findings required for such an exemption. Accordingly, the Department believes that it is premature to consider whether a self-regulatory organization could ultimately perform this function.

Solicitation of Comments

The Department is conducting an intensive study of the feasibility of making use of self-regulatory organizations in the administrative exemption process and believes that comments from interested members of the public will be of significant assistance in conducting this study. Although the Department invites, and will consider, comments on all aspects of the SRO concept, it specifically invites comments on the following:

1. Whether any existing private groups have the essential characteristics of independence, expertise and continuity to serve as a self-regulatory organization in the context of the ERISA exemption process. Comments addressing this issue should identify the group or groups that might serve a self-regulatory function and describe their structure and operations.

2. Whether there is any interest on the part of one or more groups of fiduciaries or other parties in interest in establishing and supporting self-regulatory organizations. Comments addressing this issue should identify the group or groups involved and describe the purposes of any proposed organization.

3. Whether there are any practical impediments to the use of self-regulatory organizations in the ERISA exemption process. In this respect, the Department is particularly interested in comments addressing the potential consequences of application of the Federal Advisory Committee Act (FACA) to the activities of a self-regulatory organization.[**] FACA applies to any group that is established or utilized by a Federal government agency "in the interest of obtaining advice or recommendations." Among other things, FACA requires that the advisory committee operate under a written charter, that it hold open meetings and that it perform solely advisory functions.

4. Whether some form of "negotiated" procedure could be used by the Department in developing prohibited transaction class exemptions.

5. Whether there are other functions that a self-regulatory organization might perform. For instance, could an SRO compel adherence to high standards of conduct developed by the organization through the imposition of meaningful disciplinary actions?

Three copies of each respondent's comments should be mailed or delivered to the Administrator of the Office of Pension and Welfare Benefit Programs at Room S4510, U.S. Department of Labor, 200 Constitution Avenue NW., Washington, D.C. 20210, and should be marked "Attention: SRO inquiry." Comments should be received on or before [insert date 60 days from date of publication in the **Federal Register**].

All comments received by the Department will be available for public inspection and copying in the Public Disclosure Room of the Office of Pension and Welfare Benefit Programs, Room N4677, 200 Constitution Avenue, NW., Washington, D.C.

Signed at Washington, D.C., this 4th day of December 1984.

Robert A.G. Monks,

Administrator, Office of Pension and Welfare Benefit Programs, United States Department of Labor.

[FR Doc. 84-32073 Filed 12-7-84; 8:45 am]

BILLING CODE 4510-29-M

[**] 5 U.S.C. App. II. The General Services Administration has issued interim regulations under the Federal Advisory Committee Act, 41 CFR 101-6.1000, et. seq.

POSSIBLE USE OF SELF-REGULATORY ORGANIZATION(S) IN THE ERISA PROHIBITED TRANSACTION EXEMPTION PROCESS

SUMMARY OF RESPONSES
Made to the Federal Register Notice
of December 10, 1984

OFFICE OF PENSION AND WELFARE BENEFIT PROGRAMS
U.S. DEPARTMENT OF LABOR

APRIL, 1985

I. Background

In June, 1984, the Secretary of Labor established the National Pension Forum and charged it with reviewing the administration of Title I of ERISA by the Office of Pension and Welfare Benefit Programs (OPWBP). The Forum's summary report included the recommendation that OPWBP study the concept of a self-regulatory organization (SRO) as a means to improve the ERISA prohibited transaction exemption process.

Two Department of Labor (DOL) offices, OPWBP and the Solicitor's staff (SOL), spent several months studying the SRO model in late 1984. In December, pursuant to the Forum's recommendation, OPWBP placed a notice in the Federal Register formally soliciting comment on an SRO. This paper will summarize the responses to that notice.

II. Current Procedures

In order to understand the potential utility of an SRO, it is necessary to sketch the current procedures used for prohibited transaction exemption applications. Each year, OPWBP processes between 675 and 975 applications, which pertain to increasingly complex financial arrangements. In an era of budget cutbacks and personnel reductions, it is clearly unrealistic to assume that greater numbers of OPWBP staff can be assigned to handle the growing number of applications. Similarly, it is unlikely that a federal agency will ever be able to attract and retain personnel with the sophisticated financial expertise specifically required by specialized transactions (e.g., real estate, securities, etc.). But without such skills, it takes OPWBP an increasing amount of time to process all but the most traditional exemption applications. As a result, the annual backlog of applications during the last four years has run between roughly 320 and 580.

The rationale for an SRO lies in the belief that better use of private sector expertise could enhance OPWBP's own capabilities, particularly in complex financial analysis. SROs are successfully used in the Federal Government, the most notable examples being the Financial Accounting Standards Board (FASD). In both cases, a Federal agency retains legal authority over all final actions; the SROs are used to expedite the decisionmaking progress.

The time now required to process an ERISA application ranges from two weeks to more than a year. Clearly, this does not work to the benefit of ERISA plan beneficiaries whose trustees presumably are watching desirable investments disappear as they wait for OPWBP to act. It is also evident that a lengthy exemption process is costly to the applicant, who is apt to be paying a service provider to assist in the application process, even as he may be losing out on the return of a good investment. If an SRO could help improve this situation, it should be explored.

It should be emphasized that OPWBP views the SRO as offering an alternative method to the prohibited transaction exemption process currently in use. Authority to use alternatives does exist in Section 408(a) of ERISA. The existing exemption process would continue to be available; use of either option would always require final action by DOL.

III. Responses to the Federal Register Notice

On December 10, 1984 the Federal Register notice soliciting comments on an SRO listed several general questions for consideration. They included the following:

- What sort of membership and responsibilities should an SRO have?

- How should it be funded?

- Is there an existing organization with the independence, expertise and continuity that might serve as an SRO?
- Should there be one SRO or several?
- How can broad representation in an SRO be guaranteed?
- What functions other than exemption assistance might an SRO perform?
- How, and should, the SRO concept be explored further?

Twenty-eight responses to the Federal Register notice were submitted. OPWBP is grateful for the time and thought reflected by all the submissions, which were written by:

Richard Alpern
Subcommittee on Fiduciary Responsibility,
American Bar Association

Richard Bail
Gaston Snow &
Ely Bartlett

Herbert Boothroyd
New England Mutual Life Insurance/
American Academy of Actuaries

Stuart Brahs
Association of Private Pension and
Welfare Plans

John Casey
Scudder, Stevens & Clark

George W. Cowles
Bankers Trust Company

J. Hamilton Crawford
Securities Industry Association

Joseph Gamble
Torchmark Corporation

Harry Garber
The Equitable Life Assurance
Society of the U.S.

James McLaughlin
American Bankers Association

Richard McLaughlin
The Travelers Companies

R.B. Peters
Mobil Oil Company

Honorable Edward Roybal
Chairman, Select Committee
on Aging

Joseph Sciarrino
Financial Executives Institute

Stewart Shepherd
Hopkins & Sutter

R. Philip Steinberg
Drinker, Biddle & Reath

Robert Stokes
Cravath, Swaine & Moore/
Subcommittee on Fiduciary
Responsibility, American Bar
Association.

Seth Tievsky
Lee, Toomey & Kent/
Subcommittee on Fiduciary
Responsibility, American Bar
Association

Mark Ugoretz
ERISA Industry Committee

Ralph Winger
Cahill, Gordon & Reindel

Robert Zinman
Metropolitan Life Insurance Company/
Real Estate Division, American Bar
Association

Robert A. Georgine
National Coordinating Committee
for Multiemployer Plans

Catherine Heron
Investment Company Institute

Frederick Hunt
Society of Professional Benefit
Administrators

Honorable Jacob Javits
Chairman, National Pension
Forum

Ronald Keller
Bankers Life Company

Sophie Korczyk
Employee Benefit Research
Institute

Stephen Kraus
American Council of Life
Insurance

In summary, the responses indicated the following:

A. Funding

Various funding mechanisms were suggested, including membership fees and hourly processing charges incurred by a given application. It was noted that funding be carefully controlled to support needed staff and services, but not to encourage another "ballooning bureaucracy."

B. Representation

Given the broad range of ERISA constituencies, many respondents stressed the importance of fair representation. Specific reference was made to protecting the interests of in-house pension funds, plan sponsors, plan beneficiaries, investment, banking and insurance companies as well as other groups active in managing ERISA plans.

Many sources have made it clear to OPWBP that the single group of ERISA constituents with the greatest stake in improving current procedures is the plan sponsors. It has been noted that sponsors are the only ones who must concern themselves with the entire ERISA system; service providers, by contrast, are generally involved in only one aspect. This would support the notion that plan sponsors must play a pivotal role in the creation and operation of an SRO.

Several respondents asked whether the lack of common interests among all ERISA constituencies would preclude the effectiveness of an SRO. It was suggested that multiple SROs in a variety of fields would be a reasonable way to address diverse needs.

The responses included the suggestion that existing private sector organizations be examined for a possible SRO role.

C. Function

Most respondents agreed that any mechanism that could expedite exemption applications was worth exploring. They suggested that in the beginning an SRO confine itself to prohibited transactions, and then "graduate" to other services for its members; that procedures for OPWBP-SRO cooperation be clearly defined and emphasize prompt action by both; and that the SRO be staffed with financial experts. It was noted that mutual OPWBP-SRO respect and trust would have to underlie a constructive working relationship. Respondents warned against creating one more level of bureaucratic review that in fact would do nothing to speed up the exemption process.

D. Other Issues

Respondents raised a number of questions about an SRO that merit consideration. ,These included:

- How, and to what extent, would the Federal Advisory Committee Act apply to the operation of an SRO?
- How would a governing board be appointed?
- How would conflicts of interest be avoided?
- How would an SRO exercise discipline over its members; one respondent noted that ideally an SRO would serve to let the ERISA industry "police itself."

E. Next Steps

Almost all respondents supported further study of an SRO, and many volunteered to work with DOL in such an effort.

Specifically, there were suggestions that:

- a joint DOL-private sector task force be convened for the purpose of further work on the creation of an SRO.
- an SRO be tested by means of a "pilot," similar to the OPWBP electronic filing project, which should include a cost-benefit analysis.

It is apparent to DOL that the primary initiative for an SRO must come from the private sector and specifically from plan sponsors, for it is their interests that would guide its form and function. The Department, and OPWBP, are receptive to such an initiative, and would make every effort to assist in moving this concept forward.

[From Barron's, June 10, 1985]

A NEW FIDUCIARY DILEMMA FOR MANAGERS

(By Robert A.G. Monks)

Since its passage in 1974, the Employee Retirement Income Security Act (ERISA) has prompted the growth of a vast private pension fund industry. There are now more than 800,000 pension plans, whose assets total approximately one trillion dollars. Government estimates show this figure rising to three trillion (in constant dollar) over the next fifteen years.

The growth in ERISA plans, and the businesses that serve them, has occurred so rapidly that observers are only beginning to appreciate the impact of pension funds on the economy. There are several known factors, however, that can guide an attempt to measure this impact. First, the establishment of a private pension plan is voluntary. Should an organization decide to establish a plan, it must conform to ERISA requirements in setting it up; the requirements include the designation of a fiduciary who will comply with strict standards of conduct regarding the plan. The law does permit the delegation of fiduciary responsibility. Indeed, reviews conducted by the Labor Department early this year indicate that ERISA has actually encouraged delegation; to the extent that a plan sponsor can point to many layers of financial experts who approved this investment strategy, he will have ipso facto proved the "prudent" nature of his behavior.

It is in the act of delegation, however, that the problem lies. Since ERISA does not mandate a given objective in terms of post-retirement income, there is no standard against which to measure performance. The nature of a competitive market has meant that each money manager has developed his own performance rating system, which many managers freely admit is used primarily as a marketing tool. Even more importantly, delegation often extends to voting responsibilities as well as money management. Recent developments have highlighted the several reasons that this poses a dilemma for the manager.

Voting shareholdings for pension funds is problematic for several reasons: it is difficult to delegate, it is inconvenient for delegatees to exercise; and it creates conflicts of interest. The investment manager retains clients by delivering good performance; no plan sponsor adds to the performance measure credit for thoughtful consideration of corporate governance issues. Yet on the other hand, take the money manager who makes a serious effort to vote shares responsibly; voting against the anti-takeover proposals of a current or prospective client is seldom perceived as the best way to establish a warm relationship. Moreover, the voting right is inconvenient: no one is paid for the work involved in exercising the franchise responsibility "prudently"; no one is protected against the liabilities that may arise from controversial votes (or the failure to vote); there is no schooling or professional background in "proprietorship"—most decisions are matters of first impression.

Bear in mind that ERISA plans must be invested and managed for the "exclusive benefit" of the plan participants and beneficiaries. This requirement encompasses the exercise of voting power every bit as much as the investment power. But consider the dilemma this poses for major ERISA money managers: the banks, insurance companies, and securities conglomerates. Let's take the hypothetical Company A, whose ERISA funds are managed by Bank B. The Bank also manages pension portfolios for ten other large companies, and has purchased Company A stock for all ten. Enter Company A's pension officer one day, with an additional ten million in pension funds for the Bank to manage, and coincidentally, a small request. Company A's annual meeting is coming up, and a certain anti-takeover measure is on the proxy; Company A surely would appreciate it if Bank B could make sure all the proxies it holds are voted the right way. Needless to say, the Bank justifiably worries about keeping Company A as a valued client. But it also holds trustee responsibility for ten other pension portfolios, whose best interest may well lie in Company A being available for acquisition.

Are such exchanges taking place? In the Wall Street Journal of May 10, an unnamed money manager was quoted as saying that he in fact had received calls from Unocal officers on exactly this issue. When one considers the few large entities that control the bulk of pension fund assets—in 1984, the one hundred largest companies owned more than half the assets—it is clear that there are extensive overlapping networks of "connected" companies who have commercial relationships with virtually every significant financial service provider. The number of phone calls that could be arranged to a fiduciary with an "unacceptable" view of exercising his responsibilities boggles the mind—it is a very large number.

Chairman John Shad of the Securities and Exchange Commission recently said, "There could well be a backlash from corporations. Corporate managers might go to the institutions and complain. 'Hey, wait a second: you're managing our pension funds and you're opposing our anti-takeover proposals.' I don't know how some of these conflicts of fiduciary problems will be shaken out."[1] Neither does anybody else. Absolute power over the selection, and the discharge, of trustees lies in the hands of the plan sponsors. Up until the most recent takeover embroglios, there has been little occasion to speculate about how the conflicting power arrangements would be reconciled, simply because fiduciaries have rarely voted differently from management. Banks have devised "Chinese Walls" to accommodate functioning on both sides of a conflict of interest. Usually, the wall is unveiled when the bank acting both as a lender to and owner of an enterprise. As a lender, it is in the position to learn a great deal about the financial affairs of the corporation that are not available to the general public. The wall protects this information from the trust department which must continue to make its investment decisions with the benefit only of information available to the general public. Although no practice has yet been made formal, the concept of a wall appears to be satisfactory when one department of a bank is required to make decisions that are unwelcome to a client, whose other business is simultaneously being nurtured by different departments of the bank.

Possibly, special purpose institutions will be needed to exercise fiduciary functions. The present situation strains credulity; it simply does not make sense to require an institution to act contrary to its own interests. What will ultimately determine how these problems are resolved in the future is the extent to which those responsible for enforcing the provisons of ERISA (and, of course, the courts) require that fiduciaries function "solely" in the interest of their beneficiaries. There is no such thing as a "satisfactory" conflict of interest, or Chinese Wall for that matter, under ERISA. Indeed, ERISA does not require that fiduciary responsibility be delegated at all. Employee benefit plans can be managed in-house. Many are, including some of the most successful.

Along with the problem of conflicting interests, the developing ERISA law creates great uncertainty for institutional fiduciaries. Once a trustee has been appointed, will it be considered legal for a plan sponsor to discharge the trustee because of difference of opinion? The trustee is obligated to exercise discretion irrespective of the impact on other commercial relationships. The infamous Benedix-Martin Marietta case came down to a critical decision by the trustee of Bendix's employee savings plan (SESSOP), Citibank, that it was obligated to tender the shares of Bendix stock that it held.[2] Nothing could have been more unwelcome to Bendix management; 95% of Bendix employees ultimately voted to withdraw their shares from the tender. It is not clear that Citibank even had the power to tender the shares; in a 1981 tender for four million of its own shares, Benedix said in a formal prospectus describing the offer, "The trustee of SESSOP does not have discretionary authority to tender shares pursuant to the offer."[3] All of this notwithstanding, Citibank felt obligated to tender because of the overrriding fiduciary obligation to protect the best possible alternatives for its beneficiaries.

During the summer of 1984, Carter Hawley Hale (CCH) successfully defended against a takeover. One of the critical factors was the role of Bank of America, trustee for the employees' stock savings plan, which turned out to hold 40% of the outstanding ownership of the company. Bank of America, whose directors included CCH Chairman Philip Hawley (who also chaired the executive compensation committee of the Bank's Board), declined to tender shares at the offered price, which was the highest ever. Confusion still reigns. "The biggest question is why the Department of Labor has not acted on its apparent intentions to sue the Bank of America, which is the trustee for Carter Hawley's employee profit-sharing plan. In it June 21 proxy statement for today's shareholder meeting, Carter Hawley stated that the Labor Department had notified the Bank of America on May 9 of the agency's intention to seek an injunction against the bank, charging violations of the Employee Retirement Income Security Act of 1974. . . . While the Labor Department has not detailed its concerns, they are said to center on the bank's purported failure to evaluate the impact of the tender offer on the participants' benefits and its failure to recommend a vote either way to the employees. There is also some question as to . . . conflict of interest."[4]

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[1] Bruce Ingersoll, Wall Street Journal, June 7, 1984.

[2] Allan Sloan, Three Plus One Equals Billions (New York, 1983), pp. 203-205.

[3] Ibid, p. 204.

[4] Isador Barmash, New York Times, July 26, 1984, p. D4.

Although a very substantial, and growing, percentage of the voting stock of corporate America rests in funds subject to ERISA, the dynamics underlying the exercise of ownership rights are not yet clear. It seems reasonable to conclude that a succession of cases involving conflicts of interest will result in law clearly requiring that a fiduciary make decisions solely in the interest of trust beneficiaries. Whether this is accomplished by walls, recusals, or delegation is not all-important. What is essential is that some accountable entity be obligated to exercise ownership responsiblity on behalf of the beneficial owners. Presumably this result obtains even in the cases where a company acts as trustee for its own employee benefit plans. ERISA requires a fiduciary and its requires that the fiduciary act as such. For the immediate future, the power of plan sponsors to choose and change fiduciaries may delay the emergence of genuinely independent trustees, but given the "handwriting on the wall," major sponsors will doubtless begin to figure out how to deal with this new reality.

[From the Wall Street Journal, May 10, 1985]

UNOCAL IS SEEN GAINING ON MESA IN PROXY FIGHT

(By Laurie P. Cohen and Frederick Rose)

Unocal Corp. apparently is winning support among certain crucial shareholders in its proxy fight with an investor group led by T. Boone Pickens Jr.

Mr. Pickens is seeking to adjourn Unocal's annual meeting Monday to give his group time to pursue its takeover bid for the company. Unocal is resisting the takeover bid and the adjournment motion.

The adjournment vote is expected to be close, and neither side is willing to disclose how many proxies it has or to predict the outcome. But in the past few days there have been growing indications that the Pickens proxy solicitation campaign may be in trouble.

Mr. Pickens, chairman of Mesa Petroleum Co., has focused much of his effort on persuading Unocal holders to vote to adjourn the annual meeting until June 28. A delay would allow the Pickens group time to nominate candidates for Unocal's board and possibly to propose restructuring the Los Angeles-based oil company. Such a delay is important to the takeover attempt because Unocal's elaborate defenses make it difficult to challenge management at any other time.

Generally, it appears that the Pickens group's strength lies with big institutional holders, which control a quarter of Unocal's 173.9 million shares outstanding. The Pickens group itself holds 13.6%. Unocal's strength seems to be among the 40% held by individuals and by brokerage houses on customers' behalf. The remainder is believed to be held by Unocal's pension funds, Wall Street takeover speculators, foreign holders and foundations.

Unocal lately appears to have made progress among some important holder groups. For example, most of a group of regional banks, which control an estimated 10% of Unocal's stock, say that after lobbying by both sides they intend to vote their shares for Unocal. A larger holder, Bankers Trust Co. of New York, which previously indicated it would vote its 3.5 million shares with the Pickens group, now is undecided, following a meeting with Unocal officials earlier this week, Wall Street sources said.

Just before April 29, when the annual meeting originally was scheduled, both sides claimed to be winning. A federal judge hearing litigation stemming from the takeover fight ordered that the meeting be postponed until Monday.

Meanwhile, the campaign has intensified. Mr. Pickens himself has called one major institutional holder twice in recent days in a vain attempt to woo its vote. "They must really need the votes if they're doing that," said an executive at the institution, which asked not to be identified. Mr. Pickens said he has called about a dozen institutions in recent days to seek their support.

Having failed with some institutions, Unocal has gone directly to their clients. Ordinarily, such clients tend to stay on the sidelines. A manager at one institution reported receiving instructions from clients, whose shares the institution holds to switch the shares' votes to Unocal from Mesa. "This is unprecedented here," the managers said, adding that the calls he has received represent about 20% of the institutions' Unocal holdings.

Unocal is beating the bushes pretty hard with everybody, but especially with the smaller, less-sophisticated guys who can be easily presuaded," said one source close to Unocal. The company has deployed several hundred proxy solicitors, including Unocal directors who have intervened with some banks.

Some banks said they were siding with Unocal in exchange for a commitment from the company that it will proceed with its offer to buy back 29% of its stock for $72 a share in notes. Unocal is trying to exclude the Pickens group's stake from that offer, and Mr. Pickens and others have expressed doubt that Unocal will go ahead with the offer, which expires next Thursday. "We're using the power of our votes as a carrot to give management a message to deliver on the offer," one banker said.

In some cases, institutional managers seem to be swayed by their distaste for the methods of Mr. Pickens, whose group last month made its $54-a-share, or $3.4 billion, offer to gain control of Unocal. "There's a lot of hostility around here against raiders like Mr. Pickens making big bucks for themselves," said one manager. In past takeover battles, the Pickens group has ended up dropping its bids after the target companies agreed to buy back the group's shares at a premium.

Ultimately, the outcome of the proxy fight, may be determined by whoever can sway major holders who are waiting until the last minute to vote. Those holders include Security Pacific National Bank, which administers Unocal pension plans representing a 7% stake in the company, and Bankers Trust and Wells Fargo Bank, which together control an estimated 3% of the company's shares.

[From the Wall Street Journal, Oct. 30, 1984]

TAMING THE CORPORATE TAKEOVER

(By Peter F. Drucker)

What explains the takeover wave that is engulfing American industry? Should it be stopped? Any can it be stopped before it does irreparable harm? I am asked these questions every time I sit down with senior executives, middle managers or union leaders. The questions are also increasingly being asked by bankers or Wall Street people despite the immediate gains they derive from unfriendly takeovers.

It is increasingly hard to defend the unfriendly takeover as benefiting anyone other than the raider (and a few investment bankers and merger lawyers). Anyone working with management people knows that fear of the raider paralyzes our executives. Worse, it forces them into making decisions they know to be stupid and to damage the enterprise in their charge. A good many experienced business leaders I know now hold takeover fear to be a main cause of the decline in America's competitive strength in the world economy—and a far more potent cause than the high dollar. It contributes to the obsession with the short term and the slighting of tomorrow in research, product development, market development and marketing, and in quality and service—all to squeeze out a few more dollars in next quarter's "bottom line."

EMPLOYEES DEMORALIZED

But also, employees, from senior middle managers down to the rank and file in the office or factory floor, are increasingly being demoralized—a thoughtful union leader of my acquaintance calls it "traumatized"—by the fear of a takeover raid.

The very shareholders who accept the raider's bid clearly do not believe it to be in the best interest of either the acquiring company or the one about to be acquired. Announcement of an unfriendly bid is followed almost as a matter of routine by a drop in the share price of the bidding company. After they have voted to accept the raider's bid, most of the former holders of the acquired company at once sell the securities they received in exchange, thus giving the acquirer a rousing vote of non-confidence. Indeed, the great majority of companies acquired through an unfriendly takeover have done worse under the new ownership than they did when they were independent. One reason for this is that the successful raider immediately strips his new acquisition of its best assets and drains it of cash—both to repay what he borrowed to buy the business and to make a quick killing.

It is thus highly debatable whether the unfriendly takeover is even in the best interest of the shareholders. It may be more nearly correct to say—as a banker friend of mine said recently—that in its opposition to any restriction on takeovers, the SEC, founded to protect the investor against the financial wolves, has now become the protector of the wolves.

And yet neither shareholders who accept a takeover bid they know to be deleterious, nor the SEC, have much choice. The holders whose votes decide the outcome have a legal duty to accept the bid. They cannot exercise the owner's right—indeed, the owner's responsibility—to make a decision, e.g. to weight long term vs. short term. They are fiduciaries. At least one-third of the equity of our publicly owned companies—50% for the big ones—is held by "trustees"—pension funds foremost, mutual funds second. And fiduciaries have a legal duty to accept whatever gives their beneficiaries the highest immediate return. If, for example, the fiduciaries turn down a raider's bid that was a little higher than the stock-exchange quotation, they are liable for severe damages if the company's stock then does not go up, and soon. The pension-fund and mutual-fund managers whose votes decide the outcome may doubt the wisdom of a proposed merger or its benefits to either the acquiring or the acquired company—and they do have doubts most of the time. But they are legally bound to accept the bid. The wave of unfriendly takeovers is thus the price we pay for that great achievement, the pension fund.

But is it a necessary price? More and more people doubt it. We can expect—maybe no later than the next big, bitter, controversial takeover battle—several proposals to ban, or at least to curtail unfriendly takeovers.

One proposal being quietly discussed by Washington's congressional staffers and by senior officials in the Treasury, Commerce and Labor departments is to have the Comptroller of the Currency forbid banks to make loans to finance takeover bids. I expect this proposal to surface the next time Congress debates regulation or deregulation of financial institutions. Some lawyers argue that the Comptroller already has the power to stop such loans. And with the Comptroller being pushed by the troubles of a few big banks into becoming more "activist," he may well, in a new administration, do something that, however unpopular with the banks and with Wall Street, would be applauded on "Main Street." Such a ban would put a stop to most, perhaps all, unfriendly takeovers.

A second proposal is being considered seriously in a few states with strong and politically powerful "high-tech" enterprises: Massachusetts, Minnesota, California, Colorado. It is to build legal delays into takeover proposals: a waiting period on nine months; a holding period of a year before the successful acquirer can sell any assets or touch the cash of the acquired business; or delaying the vote on the acquisition until the bidder has submitted a detailed and legally binding plan in which he outlines what he will do with the company he intends to buy. An approach favored by one powerful state official is to demand that the bidding company commit itself in advance to specific performance goals for the target company in respect to investment, sales, profit and employment, with penalties payable to shareholders and former employees should the goals not be reached.

Finally, there is increasing interest in the way the British are tackling the problem. They have a "Take-Over Panel" to which the government routinely refers unfriendly takeover bids for a final "yes" or "no." The advantage of this approach is that it allows takeovers, no matter how highly contested, if deemed justified and beneficial. But do we really need or want another government agency?

In one of these ways—or in a way no one has thought of yet—we will, I am reasonably sure, do something to curb the unfriendly takeover, and fairly soon. It is likely to go the way of the equally prominent financial ploy of the 1920s, the pyramided public utility holding company. But there is a danger that the policies we adopt will be punitive rather than remedial, and will encroach on the freedom of business enterprise rather than strengthen it. This only means, however, that business had better think through what the policies should be instead of waiting for the "scandal" that pushes the politicians into demagoguery.

THE SHIFT OF VOTING POWER

And none of the policies we are likely to adopt will solve the basic problem, the one created by the shift of voting power from "owners" to "fiduciaries." The classical defense of ownership has always been that the "owner" has an abiding, long-term interest in the welfare of his property and that, therefore, his decisions are more likely than those of anyone else to balance and optimize the interests of all who have a stake in the enterprise: those of the owner, to be sure, but also those of employees, creditors, suppliers, customers, the economy and society in general.

The owner's self-interest, argued the Roman lawyers 2,000 years ago when they developed the legal concept we now call "property," was most nearly compatible with the true interest of the enterprise. But the new legal "owners" of our publicly owned businesses are forbidden as fiduciaries even to consider the interest of the enterprise. Can and will any society tolerate this? Can it even be defended as legitimate power? And how do we reconcile the justified interest of beneficiaries who need to be "investors" rather than "owners," and whose priorities therefore are quite properly liquidity and the fast buck, with the welfare of society's wealth and job producing asset: the going concern, the enterprise?

[From the Wall Street Journal, Nov. 28, 1984]

Letters to the Editor

PENSION FUNDS AS STOCKHOLDERS

Peter F. Drucker, in his Oct. 30 editorial-page article on corporate takeovers, assumes that institutional investors "have a legal duty to accept whatever gives their beneficiaries the highest immediate return." While I cannot speak about other institutional investors, I can say that the Employee Retirement Income Security Act (ERISA) which regulates private pension funds does not require pension fund fiduciaries to act in such a simplistic manner. It requires that a fiduciary, in evaluating such a bid, must act prudently and solely in the interests of plan participants and beneficiaries. This requires a careful evaluation of long-term prospects of the company under existing management as against the short-term prospects presented by the takover offer and by the ability to invest the proceeds elsewhere.

The logic of Mr. Drucker's statistics—that at least one-third of the equity of our publicly owned companies and 50% of the big publicly owned companies are owned by institutional investors—would argue for a determination that, if anything, institutional investors have to act more like long-term owners and less like mere traders in the market, since their size relative to the market will make it increasingly difficult to move into and out of positions.

If a company is fundamentally strong and an institutional investor believes that it will do better over time under its current ownership, the investor's duty would be to vote against the takeover. Mr Drucker seems to assume that it is the fate of every takeover candidate which successfully defeats an offer to inevitably sink to a price lower than the offer, which he assumes to be unrealistically high in the first place. I am not willing to make either assumption. The fiduciary shareholder has a duty to examine each offer on its merits.

I do agree with Mr. Drucker, however, that institutional fiduciaries appear to be lax in performing their duties as owners of the corporation. Institutional shareholders, who often have both the knowledge and the ability to act, should move to correct deficiencies in a corporation before any question of a takeover arises. This occurred several years ago in Britain when the institutional shareholders in the Rank-Xerox Corp. determined that there were major problems not being addressed by the directors. The institutions moved to install a new board so that the corporation could get back on track.

Robert A.G. Monks, Administrator of ERISA, Labor Department.

REPORT
EVALUATION AND RECOMMENDATIONS
ERISA ENFORCEMENT

JOINT OIG-LMSA TASK FORCE
DEPARTMENT OF LABOR
WASHINGTON, D.C.

MAY 1, 1982

MEMORANDUM FOR: THOMAS F. McBRIDE
DONALD L. DOTSON

May 1, 1982

FROM: JOHN J. WALSH, Coordinator

There are transmitted herewith copies as follows of the report of the Joint OIG-LMSA Task Force entitled, "Report, Evaluation and Recommendations, ERISA Enforcement."

OIG - 3 copies
LMSA - 5 copies

During the course of this project, volumimous documents and workpapers were generated. In accordance with the commitment confirmed by both of you, representations were made to the persons interviewed in the field and in the National Office that their identity and the information they furnished would be held confidential and they would not be openly identified in the report.

Therefore, in accordance with this commitment 5 cartons of documents and workpapers, (one for each of the 5 joint teams assigned to the project) have been prepared and sealed. They were sealed inasmuch as they contain the results of the field interviews. In accordance with arrangements made with the Inspector General, these 5 sealed cartons of documents and workpapers were delivered to A. M. Statham, Assistant Inspector General for Investigations. The 5 cartons will be maintained in a locked and secure room.

Each box was identified as containing material generated by a specific team and bears a label with the notation.

"WARNING - DO NOT
REMOVE OR OPEN
WITHOUT THE PERSONAL
APPROVAL OF A. M. STATHAM,
ASSISTANT INSPECTOR
GENERAL FOR INVESTIGATIONS."

In addition to the above, a number of documents, reports, memoranda, etc. were collected during the course of the project. Many of these documents are referred to in the report but are too bulky to duplicate and attach to each copy. To facilitate access to these documents, if necessary, a list of them has been prepared and numbered and is attached to each copy of the report. One complete set has been placed in numbered folders in a carton. This carton is located in the Office of Inspector General, Room S-1303 where they will be available for inspection. A log will be maintained to document the granting access to them.

Finally, I have hand delivered a copy of the report to the Office of the Secretary and to the Office of the Under Secretary. An additional 10 copies of the report have been made and will be embargoed until June 1, 1982. These copies will be maintained in the Office of Legislation and Intergovernmental Relations where they will be logged and issued upon approved requests after the embargo.

John J. Walsh

EXECUTIVE SUMMARY

On March 11, 1982 a committee of 10 DOL employees was formed, under the direction of a consultant, to perform an operational review of the efffectiveness of ERISA enforcement, identify management problems and recommend solutions. During the project fifty (50) interviews were conducted, one hundred and forty eight (148) investigative files were reviewed and a total of 71 recommendations for improvement are included in this report.

ENFORCEMENT STRUCTURE

- Line authority for PWBP field employees is through the Office of Field Operations and not the PWBP Administrator.
- 49% of all PWBP staff are in the National Office.
- The ratio of non-supervisory field investigative staff to field managerial/supervisory staff is 2 to 1 and the ratio of non-supervisory field investigative staff to total PWBP staff is 1 to 2.
- Levels of review involving investigative reports are excessive.
- PWBP staff has been reduced by 29% since FY-78 and the current non-supervisory investigative staff appears grossly undersized.

ENFORCEMENT POLICY

- Current enforcement policy is vague, ambiguous and incomplete.
- The significant case process has resulted in inadequate coverage of smaller plans and an unbalanced enforcement policy.
- Criminal investigations have been discouraged by the National Office.
- The Solicitor's Office has had more influence in setting enforcement policy than PWBP.

INVESTIGATIONS

- Excessive time is spent writing investigative reports where there are no violations or which do not develop into litigation referrals.

- Qualitative measurements called for in the 1978 Compliance Strategy Document have not been implemented.
- Only 24 matters involving potential criminal violations have been referred to the Department of Justice since January 1980, however, PWBP has not been informed of the results.
- There is no systematic tracking of the Statue of Limitations on cases.
- About 57% of the 2201 cases processed in FY-81 were closed without a violation; about 24% were closed with a violation(s) and about 9% were referred to the National Office for litigation.
- Eleven(11) cases are summarized in this report and cited as being seriously deficient and involve all DOL levels.

PROTECTION OF ASSETS

- Voluntary compliance letters, on occasion, have been ignored as violators believe a lawsuit will not be filed.
- IRS referrals have been ineffective because IRS usually takes no action and there is little or no PWBP follow-up.
- Lack of an aggressive and comprehensive litigation strategy is the main reason for the serious reservations about the effectiveness of PWBP's ability to protect plan assets.
- Definitional problems are evident in the preparation of the PWBP Quarterly Accomplishments Reports.

INFORMATION SYSTEM

- FARS is not useful as a management tool and is useless in ERISA enforcement.
- Manual statistical systems are used in the field because FARS is viewed as inaccurate, untimely, and confusing.

PLANNING

- The POP is of no value in ERISA enforcement because quantity is stressed at the expense of quality.

TARGETING

- The National Office's ability to effectively target cases is severely hampered by the lack of timely receipt of 5500 reports from the IRS.
- There is no standardized targeting system being used in the field.
- There is concern that targeted cases will not be compatible with the POP.

TRAINING

- Present responsibility for field training is unclear and there is no coordinated approach.
- The National Office does not have a written training plan for employees.

CASES REFERRED TO SOL

- Until recently the relationship between PWBP and SOL has been adverserial.
- Few cases were litigated.
- The decision to litigate was made by SOL.
- SOL has, on occasion, unilaterally intervened in active investigations and, on occasion has negotiated settlements without consultation with PWBP.

DECENTRALIZATION OF LITIGATION

- Decentralization of litigation to the Regional Solicitor's is necessary.
- Decentralization would facilitate criminal referrals to the Department of Justice since referrals would be handled by the field.

RELATIONSHIPS WITH OTHER AGENCIES

- The working relationship between PWBP and LMSE is poor at all levels.
- The working relationship between PWBP and IRS is proper but distant.

- The working relationship between PWBP and the FBI is informal and PWBP rarely gets any return information.

- The working relationship between PWBP and OIG is pratically non-existent despite a memorandum of understanding. There is very little useful information exchanged for a variety of reasons.

ANNUAL ERISA REPORTS

- DOL does not have anything near exact figures on the number of plans required to file annual reports.

- There is no program in PWBP to identify non-filers.

- PWBP has great difficulty in coping with data received from the IRS.

LIST OF ABBREVIATIONS

AA - Area Administrator
AO - Area Office
ARA - Assistant Regional Administrator
DAA - Deputy Area Administrator
DARA - Deputy Assistant Regional Administrator
DOJ - Department of Justice
ERISA - Employee Retirement Income Security Act
FARS - Field Activity Reporting System
FBI - Federal Bureau of Investigation
LMSA - Labor Management Services Administration
LMSE - Labor Management Standards Enforcement
MIS - Management Information System
NO - National Office
OMB - Office of Management and Budget
OE - Office of Enforcement
OFS - Office of Fiduciary Standards
OIG - Office of the Inspector General
POP - Program Operational Plan
PWBP - Pension Welfare Benefit Program
QR & A - Quarterly Review and Analysis
RA - Regional Administrator
RIO - Resident Investigative Office
RO - Regional Office
SOL- Solicitor of Labor
TS - Track Supervisor
USA - United States Attorney

EXECUTIVE SUMMARY

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I. INTRODUCTION

On March 11, 1982, a Committee consisting of five employees of the Labor Management Services Administration and five employees of the Office of the Inspector General was formed and assigned the task of performing a joint operations review and evaluation of the effectiveness of the enforcement of the civil and criminal provisions of the Employee Retirement Income Security Act of 1974 (ERISA).

The implementation of this Committee took place as a result of discussions between Thomas F. McBride, Inspector General, and Donald L. Dotson, Assistant Secretary for Labor Management Relations. The background for these discussions was the fact that the enforcement of the provisions of ERISA has been controversial almost since the law was passed. Numerous Congressional hearings have been held where questions were raised as to the Department's effectiveness culminating in a hearing January 26, 1982, before the Senate Labor Subcommittee in which Secretary Raymond J. Donovan expressed his commitment to effective enforcement of both civil and criminal provisions of ERISA and his intent to establish an internal group to identify management problems and suggested solutions.

John J. Walsh, a former Special Agent of the FBI and a retired staff member of the Senate Permanent Investigations Subcommittee, now employed as a Consultant to the Department of Labor, was selected to direct and coordinate the activities of the Committee.

The five representatives of the Office of the Inspector General were:

Roy Wiegand	Boston Audit Office
Ed Bruso	Boston Audit Office
Ed Deutsch*	Miami Organized Crime Office
Darwin Steelman*	Philadelphia Organized Crime Office
Donald Wheeler*	Chicago Organized Crime Office
(*Former LMSA Employees)	

The five representatives of LMSA were:

William Kane	Area Administrator, Pittsburgh
John Le May	Area Administrator, Seattle
Kamil Bishara	LMSE Track Supervisor, Buffalo
Leonard Garofolo	Regional Coordinator, PWBP Office of Enforcement
Thomas Kane	Chief, Division of Reporting Enforcement, PWBP Office of Enforcement

A decision was made to form five teams and to have a team visit each of the six Regional Offices plus five Area Offices and the PWBP National Office. 45 interviews were conducted with LMSA personnel in the field and at the National Office including all six Regional Administrators. Five interviews were conducted with OIG employees in the field and 148 PWBP enforcement files were reviewed to evaluate the adequacy of case documentation and the propriety of enforcement decisions.

In addition, a considerable amount of documentation was obtained and reviewed at the National Office. The field work was performed during the last half of March 1982 and the first week of April 1982. Following the completion of the field work, the teams returned to Washington to draft the results of their interviews and file reviews and to formulate recommendations. A target date of May 1, 1982 was set for delivery of the completed report.

The material set out herein represents the best and most current documentation available within the tight time constraints available to prepare this report.

It should also be noted that the persons interviewed were encouraged to be candid based upon representations confirmed by both Inspector General McBride and Assistant Secretary Dotson that statements, opinions and recommendations given to the teams would not be attributed to any specific individual.

II. BACKGROUND:

The Labor Management Services Administration (LMSA) is a part of the U.S. Department of Labor (DOL) established by the Secretary of Labor on August 8, 1963. The Assistant Secretary of Labor for Labor Management Relations is responsible for LMSA's activities.

LMSA has, among other components, the Pension and Welfare Benefit Program (PWBP) which administers DOL responsibilities under ERISA.

PWBP has a headquarters staff in the DOL National Office (NO) and a field staff is assigned to six (6) Regional Offices (RO) which supervise twenty-four Area Offices (AO) and nineteen Resident Investigative Offices (RIO).

Congress when it enacted ERISA, said the following:

> "It is hereby declared to be the policy of this Act to protect interstate commerce and the interests of participants in employee benefit plans and their beneficiaries, by requiring the disclosure and reporting to participants and beneficiaries of financial and other information with respect thereto, by establishing standards of conduct, responsibility and obligation for fiduciaries of employee benefit plans and by providing for appropriate remedies, sanctions and ready access to the Federal Courts." (underlining added) Par. 1001, Title 29 U.S.C.A.

Among the sanctions provided were criminal penalties for certain specific acts. These criminal acts are:

1. The embezzlement, theft or the unlawful and willful abstraction or conversion of the assets, funds, monies etc. of a plan. Par. 664, Title 18, U.S.C.A.

2. The willful making of any false statements, misrepresentation of fact, concealment of or failure to disclose required information in any required plan record or report. Par. 1027, Title 18, U.S.C.A.

3. The offer, acceptance or solicitation of any fee, kickback, commission, loan, gift, etc. with intent to influence any plan operation. Par 1954, Title 18, U.S.C.A.

4. The serving of any person who has been convicted of certain enumerated crimes as an administrator, fiduciary, officer, trustee, etc., of any employee benefit plan. The willful violation of this prohibition is punishable by a fine and imprisonment. Par. 1111, Title 29, U.S.C.A.

5. The willful violation of any of the provisions of Par. 1021 through 1031, Title 29, U.S.C.A., relating to reporting and disclosure or any regulation issued thereunder. Par. 1131, Title 29, U.S.C.A.

6. The unlawful use of fraud, force, violence or the threat thereof to restrain, coerce or intimidate any participant or any beneficiary to interfere with or prevent the exercise of any right to which he is entitled under the Act. Par. 1141, Title 29, U.S.C.A.

Congress, additionally, specified in the Act the duties and responsibilities of fiduciaries. It listed certain transactions as prohibited, and provided civil remedies which could be invoked in the event that these prohibited transactions had taken place or when a breach of fiduciary duty had occurred.

The legislative history of ERISA indicates that Congress considered the six criminal acts specified to be so threatening and so dangerous to the rights of participants and beneficiaries that it prohibited them under threat of fines, imprisonment and debarment. Civil remedies only were provided for the other prohibited transactions and for breaches of fiduciary duty.

The legislative history of ERISA also indicates that Congress considered the six criminal acts so threatening and so dangerous, that it expected that plans, programs and strategy would be devised to seek out instances where theft, embezzlement, false statements, bribery, kickbacks etc. existed. DOL was given broad powers under the Act: it was given the power to specify and require reports; to examine plan books and records; to call witnesses; to hold hearings and much more. Congress expected DOL to exercise a leadership role, acting alone and with other government agencies, to develop on a continuing basis the plans, programs and strategies to detect, investigate, litigate and prosecute not only prohibited transactions and fiduciary violations covered by civil remedies in the Act, but also the criminal acts punishable by fines, imprisonment and debarment.

The vesting, funding and participation standards of ERISA are administered by the Internal Revenue Service (IRS). ERISA also established the Pension Benefit Guaranty Corporation (PBGC) to insure vested benefits for participants of most pension plans.

III. ENFORCEMENT

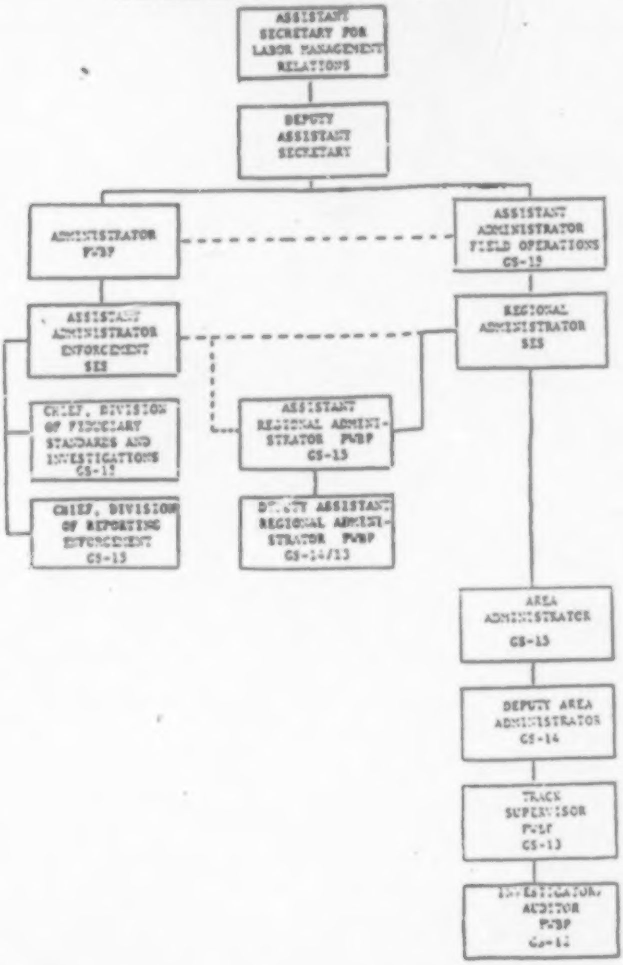
A. Structure

1. Authority

The enforcement activities of PWPB are carried out by 167 full-time PWBP investigators assigned to PWBP tracks in the 24 Area Offices throughout the country. Line authority and direction to these investigators flows from the Assistant Administrator for Field Operations through the Regional Administrators (RA); Assistant Regional Administrator (ARA); Deputy Assistant Regional Administrators (DARA); Area Administrators (AA); Deputy Area Administrators (DAA); and PWBP Track Supervisors (TS).

The following chart illustrates existing line authority in PWBP as explained to the committee:

ENFORCEMENT STRUCTURE
PENSION AND WELFARE BENEFIT PROGRAM


ASSISTANT SECRETARY FOR LABOR MANAGEMENT RELATIONS
DEPUTY ASSISTANT SECRETARY
ADMINISTRATOR PWBP
ASSISTANT ADMINISTRATOR FIELD OPERATIONS GS-15
ASSISTANT ADMINISTRATOR ENFORCEMENT SES
REGIONAL ADMINISTRATOR SES
CHIEF, DIVISION OF FIDUCIARY STANDARDS AND INVESTIGATIONS GS-15
ASSISTANT REGIONAL ADMINISTRATOR PWBP GS-15
CHIEF, DIVISION OF REPORTING ENFORCEMENT GS-15
DEPUTY ASSISTANT REGIONAL ADMINISTRATOR PWBP GS-14/15
AREA ADMINISTRATOR GS-15
DEPUTY AREA ADMINISTRATOR GS-14
TRACK SUPERVISOR PWBP GS-13
INVESTIGATOR, AUDITOR PWBP GS-12

A review of this organizational chart shows that the chain of command for all of the PWBP Enforcement Supervisory and Mangerial field positions is entirely outside the PWBP organization. Hiring; firing; transfers; promotions; disciplinary action and all such personnel actions are the responsibility of the Office of Field Operations (OFO). The Administrator of PWBP and his Chief of Enforcement have only a functional line of communication to the field. The Administrator and the Chief of Enforcement therefore have the responsibility for the enforcement of the civil and criminal provision of ERISA but they have no authority over the individuals in the field who carry out this enforcement.

The offical channel of communication is from the Administrator, PWBP to the Assistant Administrator Field Operations and from the Assistant Administrator for Enforcement, PWBP to the Regional Administrators.

This is confirmed by Secretary's Order 13-76 dated May 17, 1976, whereby the Secretary delegated certain authority under ERISA directly to the Administrator for PWBP but the authority and responsibility for directing field and management operations and system services for PWBP was delegated only to the Assistant Secretary for Labor-Management Relations.

It is also noted that an apparent conflict exists between the Position Description for the Assistant Adminstrator for PWBP Enforcement and the duties of the Assistant Administrator for Field Operations. The Position Description for the Assistant Administrator for PWBP enforcement states that the incumbent is "in charge of and responsible for all enforcement activities undertaken pursuant to Title I of ERISA which include the enforcement of that Title's fiduciary, bonding, reporting and disclosure and other provisions."

However, since these enforcement activities are carried out by field personnel over whom he has no line authority or direction, there is indeed a conflict and the actual responsibility for enforcement is unclear.

2. Staffing

PWBP has a nationwide staff of 503 allocated as follows:

National Office	-	230 (46%)
Regional Offices	-	27 (5%)
Area Offices	-	246 (49%)

NATIONAL OFFICE:

(1) Headed by an Adminstrator, Deputy Administrator and Assistant Administrator, the PWBP National Office is subdivided into 6 Office and 17 Divisions as illustrated by the following chart:

PWBP NATIONAL OFFICE STAFFING

ORGANIZATIONAL COMPONENT		STAFF	PERCENTAGE
Administrators Office		5	2.1%
Deptuty Administrators Office		2	.9%
Assistant Administrators Office		2	.9%
ERISA Advisory Council		2	.9%
Office of Communications & Public Services		27	11.8%
Assistant ~~Administrators Office~~	2		
Deputy Assistant Administrators Office	2		
Div. of Benefit Plan Infor. & Publications	4		
Div. of Inquiries & Technical Assistance	12		
Correspondence Control Unit	1		
Word Processing Unit	6		
Office of Enforcement		36	15.6%
Assistant Administrators Office	2		
Div. of Fiduciary Standards & Investigators	16		
Div. of Reporting Enforcement	18		
Office of Fiduciary Standards		41	17.9%
Assistant Administrators Office	2		
Division of Exemptions	22		
Div. of Interpretations & Regulations	15		
Control Unit	2		
Office of Policy Planning & Research		18	7.8%
Assistant Administrators Office	2		
Division of Policy Planning	6		
Division of Research & Evaluation	10		
Office of Reports & Disclosure		67	29.1%
Assistant Administrators Office	6		
Division of Receipt & Identification	22		
Division of Exceptions Processing	22		
Division of Files and Control	9		
Division of Public Disclosure	8		
Office of Reporting & Plan Standards		30	13%
Assistant Administrators Office	3		
Division of Acturial Services	4		
Division of Collective Bargaining	3		
Division of Coverage	5		
Division of Plan Standards	4		
Division of Reporting Disclosure	11		
		230	100%

(2) Within PWPB, the Office of Enforcement has a staff of 36, 15.6% of the total NO staff, assigned as follows:

COMPONENT	PROFESSIONAL	SUPPORT
Assistant Administrator	1	1
Division of Fiduciary Standards & Investigations	13	3
Division of Reporting Enforcement	16	2
	30	6

b REGIONAL OFFICES:

(1) Each of the 6 Regional Offices have 4 positions funded by PWBP (RA, ARA, DARA and Secretary).

(2) Additionally, in 3 of the Regional Offices the RA's secretary is also funded by PWBP.

c AREA OFFICES:

(1) Twenty-two (22) of the twenty-four (24) AO's are headed by an Area Adminstrator (AA); one by a Deputy AA and one AO has neither.

(2) Eight of the AO's have a DAA.

(3) Ten of the AO's have two PWBP Track Supervisors; 12 of the AO's have one PWBP Track Supervisor while two AO's have no PWBP Track Supervisor.

The charts on the following page illustrate PWBP field staffing and non-PWBP AO management staff.

ANALYSIS OF NEW FIELD STAFFING PATTERN

	RA	ARA	RPMA	CLERICAL	AA	TS	INVESTIGATORS/ AUDITORS	AIC	CLERICAL	TOTALS	REMARKS
NEW YORK REGION											
Regional Office	1	1	1	1						4	
New York AO						2	14*		2	18	*Includes 1 GS-9 Prog. Asst.
Boston AO						2	9		2	13	
Buffalo AO						1	6		2	9	
East Orange AO						1	5		2	8	
Puerto Rico AO							2			2	
PHILADELPHIA REGION											
Regional Office	1	1	1	1						4	
Philadelphia AO						2	9		2	13	
Pittsburgh AO						1	5		1	7	
Washington AO						2	8		2	12	
ATLANTA REGION											
Regional Office	1	1	1	2						5	
Atlanta AO						2	9		3	14	
Miami AO					1	2	8		2	13	
Nashville AO						1	6		2	9	
CHICAGO REGION											
Regional Office	1	1	1	2						5	
Chicago AO						2	18	1	3	24	AIC-Indianapolis
Detroit AO						1	5	1	1	8	AIC-Grand Rapids
Cleveland AO						2	8		2	12	
Minneapolis AO						1	5	1	1	8	AIC-Milwaukee
KANSAS CITY REGION											
Regional Office	1	1	1	2						5	
Kansas City AO						1	5			6	
Denver AO						1	3			4	
Dallas AO					1	2	10	1	3	17	AIC-Houston
New Orleans AO						1	2		1	4	
St. Louis AO						1	7		2	10	
SAN FRANCISCO REGION											
Regional Office	1	1	1	1						4	
San Francisco AO						2	7			9	
Los Angeles AO						2	9		2	13	
Seattle AO						1	8		1	10	
Portland AO							1		1	2	
TOTALS	6	6	6	9	2	33	167	4	42	272	

ANALYSIS OF NON-FWEP AREA OFFICE MANAGEMENT STAFF

AREA OFFICE	AREA ADMINISTRATOR	AREA ADMINISTRATOR	TOTALS
New York	1	0	1
Boston	1	0	1
Buffalo	1	0	1
East Orange	1	1	2
Puerto Rico	1	0	1
Philadelphia	1	1	2
Pittsburgh	1	0	1
Washington	1	0	1
Atlanta	1	0	1
Miami	0	0	0
Nashville	1	0	1
Chicago	0	1	1
Detroit	1	0	1
Cleveland	1	1	2
Minneapolis	1	0	1
Kansas City	1	1	2
Denver	1	0	1
Dallas	0	1	1
New Orleans	1	1	2
St. Louis	1	1	2
San Francisco	1	0	1
Los Angeles	1	0	1
Seattle	1	0	1
Honolulu	0	0	0
Totals	20	8	28

d **STAFFING RATIO'S:**

(1) Ratio of field investigators/auditors to Track Supervisors: $\frac{167}{32} = \frac{5.2}{1}$

(2) Ratio of field investigators/auditors to Track Supervisors/ARA's and DARA's: $\frac{167}{44} = \frac{3.8}{1}$

(3) Ratio of field investigators/auditors to field managerial/supervisory staff: $\frac{167}{80} = \frac{2.1}{1}$

NOTE: The 36 RA's, AA's and DAA's also devote time to other LMSA programs.

(4) Ratio of field investigators/auditors to field managerial/supervisory staff and National Office-OE professional staff: $\frac{167}{110} = \frac{1.5}{1}$

(5) Ratio of field investigators/auditors to total PWBP staff: $\frac{167}{336} = \frac{1}{2}$

3. Position Ceilings

An analysis of the history of PWBP's staffing ceilings shows a steady decline of positions in recent years amounting to a 29% loss since FY 78.

FY	STAFFING CEILING	DIFFERENCE
78	642	
79	628	-14
80	611	-17
81	519	-92
82	474	-45
83	456	-18
		-186

By memorandum dated November 24, 1978 former Assistant Secretary Francis X. Burkhardt, in an attempt to reverse this trend, wrote to the Secretary of Labor requesting DOL to appeal a cut of 17 ceiling positions by the Office of Management and Budget (OMB) Burkhardt stated his understanding was that, rather than shrink, PWBP was intended by OMB, DOL and Congress to expand to about 1200 positions. DOL did not make the requested appeal. This was the last attempt to increase PWBP staff located by the committee.

4. Results of Field Interviews

The interviews in the field and at the National Office dealing with enforcement structure concentrated upon:

- The relationships between OE; the Regional and area offices.
- The responsibilities of the personnel in these offices relating to enforcement.
- The role of OFO in enforcement.
- The effect of the vacancy in the position of Chief of Enforcement.

A. Relationships Between Offices

The field interviews disclosed that the PWBP Track Supervisor in the Area Offices has primary responsibility for case development; for personal direction and guidance to the investigators and to provide the first level of review for reports of investigations. The involvement of the Area Administrator varies throughout the 24 Area Offices. Some Area Administrators take an active role in the direction and supervision of PWBP investigations. In other Area Offices, participation is perfunctory.

At the Regional Office level, the direction and supervision of PWBP cases is carried out by the Assistant Regional Administrator for PWBP and by the Deputy Assistant Regional Administrator for PWBP. These individuals generally deal directly with the Track Supervisors in the Area Offices and not directly with the investigators. They provide additional levels of review of investigative reports.

The interviews indicated that the Regional Administrators generally have little or no direct involvement in PWBP investigations.

B. Reponsibilities for Opening, Closing and Referring Cases

The Area Offices do not have the authority to open a case for investigation; they submit a recommendation for approval to the Regional Office. Likewise, only the Regional Office can approve closing a case. The Regional Office can close cases where no violation was found or where violations exist but the subject agrees to voluntary compliance. However, when the amount involved is $500,000 or more or where the subject does not agree to the amount established by the Regional Office for voluntary compliance, the matter is referred to the Office of Enforcement in the National Office for concurrence. Cases in which litigation is recommended are sent to the OE for review and referral to the SOL.

Neither the field nor OE has had the power to order litigation; they only refer and recommend litigation to SOL. The SOL can and frequently has declined to litigate for its own reasons.

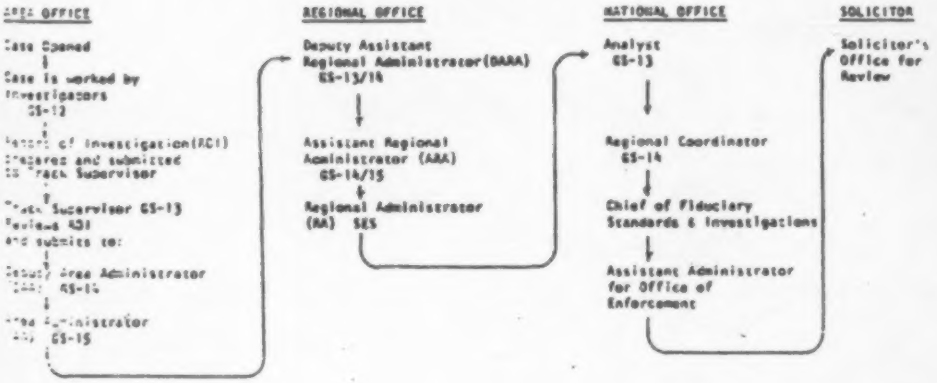
The Regional Solicitors Office plays no part in PWBP enforcement at present.

C. The Review Cycle for Reports

The interviewees generally agreed that the review cycle for reports was excessive. In one region some comments were received that the elimination of any steps in the present review cycle would decrease the quality of reports. This view was definitely in the minority and most of those interviewed cited elimination of reviews of reports, particularly at the National Office as a point in favor of decentralization.

The following chart illustrates the case flow process:

CASE FLOW PROCESS


AREA OFFICE
Case Opened
Case is worked by Investigators GS-12
Report of Investigation(ROI) prepared and submitted to Team Supervisor
Team Supervisor GS-13 Reviews ROI and submits to:
Deputy Area Administrator (DAA) GS-14
Area Administrator (AA) GS-15
REGIONAL OFFICE
Deputy Assistant Regional Administrator(DARA) GS-13/14
Assistant Regional Administrator (ARA) GS-14/15
Regional Administrator (RA) SES
NATIONAL OFFICE
Analyst GS-13
Regional Coordinator GS-14
Chief of Fiduciary Standards & Investigations
Assistant Administrator for Office of Enforcement
SOLICITOR
Solicitor's Office for Review

D. Office of Field Operations

There was near unaminity in three Regional Offices and in the National Office that the Office of Field Operations played little or no role in PWPB enforcement activities. In fact, numerous comments were received that the requirements invoked on the field by OFO for compliance with manpower allocations and unit times per case for various types of enforcement activities plus the OFO field inspections had a negative effect on field performance and accomplishments.

In one region, however, one interviewee stated OFO was, "the most important office in the structure of LMSA for enforcement and administrative purposes."

E. Effect of the Vacancy

The interviews in the field and at headquarters were nearly unanimous that the vacancy in the post of Chief of Enforcement for PWBP had resulted in negative and damaging effects on the PWBP enforcement role. Damage cited was: loss of leadership; confusion; misdirection; internal turmoil and low morale. One comment said the vacancy had contributed to the emergence of SOL as the dominant force in PWBP enforcement.

Recommendations

The committee could not agree on a recommendation as to where the line of authority and responsibility for ERISA enforcement should be. A number of proposed organizational structures were suggested and discussed at length. These were:

1. Retain the Present Structure

Under the present structure, the Administrator, PWBP and the Chief of Enforcement, PWBP, have no line authority over any field personnel and no authority to direct any enforcement decisions in the field. Line authority over field personnel is excerised by the Assistant Administrator for Field Operations who is not, however, involved in PWBP enforcement activities.

Those favoring retention of the present system argued that the Regional Administrators and Area Administrators should remain in place with responsibility for enforcement in the field for both the PWBP program and LMSE program. They stated that if this was changed, the two programs would become separate and there would be no communication between them. It was their belief that the PWBP program should be concerned with setting policy only and providing advice and technical assistance to the field.

Those who oppose the present structure argue that it is a structure where responsibility cannot be fixed; that PWBP has responsibility for making enforcement policy but no authority to carry it out. Enforcement decisions in individual cases will be made by individuals over whom PWBP has no control. PWBP has no control over the assignment of enforcement resources or the performance of enforcement personnel. The forthcoming decentralization of litigation will exacerbate the situation and an ever increasing number of disputes can be expected over controversial decisions which will have to be resolved at the Assistant Secretary level or higher. They argued also that the current survey shows there is not real cooperation in the field between the LMSE and the PWBP tracks even through the Regional and Area Administrators are in place. They also claimed that the six Regional Administrators are in effect independent and autonomous since they report officially to the Office of Field Operations which takes no part in program activities or decisions.

2. Assign Line Authority to the Administrator, PWBP.

Those favoring this shift of line authority argued that it would consolidate authority and responsibility for ERISA enforcement in one direct line under the PWBP Administrator: that it would result in a streamlined, simplified channel of command and communication; that it could probably eliminate the need for the Offices of the Regional Administrator and Area Administrator.

Those opposed to this proposal argued that it would eliminate the Offices of the Regional and Area Administrators; that it would result in LMSE and PWBP being two completely separate programs and would cut off communication and cooperation between them.

Other suggested structural changes as a possible compromise were:

- o To set up an Office of Investigations completely separate from both LMSE and PWBP and have this Office repsonsible for conducting all investigations for both programs. This office would have two tracks; one civil and one criminal.

- To transfer responsibility for enforcement of the union related pension and welfare plans from the PWBP to the LMSE track. In this arrangement, the LMSE Program would have two tracks in the field, one for labor organization enforcement and one for labor organizations benefit plans. An estimated 6000 benefit plans would be involved. PWBP would then have direct enforcement authority over the remaining 600,000 or more non-union related plans.

  Time permitted little discussion as to these suggestions. The committee, however, feels that it is the responsibility of top level LMSA management to resolve this crucial problem as to where the line of authority and responsibility for ERISA enforcement should properly be.

3. The committee was concerned about the high ratio of field managerial/supervisory staff to investigative staff and also the apparent excess of National Office staff. The following recommendations are made:

   - The committee felt the ratio of investigators to supervisors should be between 8-1 and 10-1. No recommendation is being made for overt action to correct the current imbalance but rather a need for LMSA awareness of the recommended ratio and a notation that 20 of the AOs now fall below this recommended standard.

- Elimination of the DAA position with a corresponding reassignment of staff to investigative positions.

- Elimination of the DARA position with a corresponding reassignment of staff to investigative positions.

- A close examination of existing NO staff with a need to determine whether the existing offices, divisions and units.

    a. Have a critical function and serve a need.

    b. Whether a portion of these positions could be better used in the Area Offices playing a direct role in Enforcement Activities.

B. ENFORCEMENT POLICY

As part of the review, an effort was made to obtain documentation as to the official published policy of PWBP relating to the enforcement of the civil and criminal provisions of ERISA. Although ERISA was signed in 1974, the earliest published document found relating to ERISA enforcement was the "PWBP Compliance Strategy Document" dated January 5, 1978. The Background section of this document includes the following statement:

> "This document is the first, formalized published and distributed paper which defines the compliance policy and establishes procedures to implement this policy."

The document contains little as to specific enforcement goals, guidelines or procedures. It states that DOL will emphasize voluntary compliance (i.e., request ERISA violators to voluntarily comply with the Law) in its enforcement activities. However, it recognizes that there will be many instances where voluntary compliance will not be appropriate. In these instances it was stated that the priorities of DOL will be:

1. To secure assets
2. To recover losses
3. To prosecute criminally

The document contains no discussion regarding how DOL proposes to secure assets or recover losses. It is clearly stated, however, that criminal investigations are discouraged as evidenced by the following statements:

> "Criminal investigations cannot be allowed to displace the civil investigative efforts required under ERISA"
>
> and
>
> "Criminal investigations by PWBP personnel are to be minimized."

The document also establishes a quota system for the utilization of field manpower for enforcement purposes by publishing a Table of Time Allocation Percentage Guidelines allotted to the various types of ERISA cases. These percentages were subsequently amended on July 5, 1979. At that time, the allocation mandated that 85% of field staff time be utilized in the enforcement of matters involving ERISA fiduciary standards. Allocations of staff time for other types of enforcement cases such as, reporting violations, bonding violations, audits, criminal investigations, etc. were minimized.

The 1978 Compliance Strategy Document also establishes a requirement that a bi-Monthly Report of Significant cases be prepared for the PWBP administrator. There is no clear definition of the term "significant" except to say that cases designated significant could include:

> "Those cases with high litigation potential, cases in which substantial assets or numbers of participants are involved, or cases which individuals, companies, or unions involved in or identified with past violations of this or other laws."

The number of dollars and/or participants included in a pension or welfare plan appears to have a bearing on "significance", however, the field was not given specific guidelines or direction regarding the quantative definition of "significant". Other documents which relate to enforcement policy but which contain little in addition to that set forth above are the PWBP Compliance Manual and an LMSA Notice, dated July 13, 1978, issued by J. Vernon Ballard the former PWBP Deputy Administrator. These documents confirm the priorities set out in the Compliance Strategy Document and the significant case requirement. The Notice states that each AO must have at least two significant cases pending at all times. The documents also state that the field is discouraged from soliciting authority from the U.S. Attorneys to investigate criminal cases.

In order to gather information regarding the implementation and effectiveness of the ERISA enforcement policy, committee members reviewed the documents discussed above and interviewed 45 LMSA employees.

Results of the review indicate that general dissatisfaction exists at LMSA's National and field offices regarding ERISA enforcement policy. Statements indicating that the present policy is vague, ambiguous, and incomplete were common. Also indicated was the feeling that the National Solicitor's Office has had more influence in setting enforcement policy than the policy statements published by PWBP. The Field is not advised as to the views of the Solicitor's Office in terms of enforcement policy except in individual cases. The result has been frustration for field personnel who worked on cases for months or more only to find that the Solicitor has no interest in litigating the case.

There was near unanimity regarding the significant case process in that the system is not considered a viable tool for setting case priorities, or targeting specific cases. The significant case process has resulted in too much coverage of large ERISA plans and an inadequate coverage of smaller plans. Reporting violations, particularly the deliberate failure to report, have been largely ignored as well as bonding violations, prohibited persons, terminations and criminal violations. A consensus was found that the present enforcement policy does not allow enough latitude for PWBP to detect and investigate ERISA cases which involve potential criminal violations. Criminal prosecution of ERISA violators was often cited as being needed as a future deterent to potential violators.

Discussions regarding enforcement policy indicated that LMSA offices are operating under the assumption that large fiduciary cases are the primary target of the enforcement policy, however, the definition of "large" varied greatly among the persons interviewed. The term "significant" also could not be specifically defined. Some AO's had cases designated as significant which would not be significant in other offices. One individual indicated that the significant case process coupled with the time allocation guidelines were actually counter productive since some cases were opened for purposes of satisfying these two systems and not based on the best use of PWBP enforcement resources. Most persons interviewed were in agreement that a more balanced enforcement policy is needed which allows coverage of a mix of ERISA plans and types of violations rather than concentrating nearly all resources on large fiduciary cases.

Regarding criminal investigations, field personnel were in agreement that this type of case is discouraged by the National LMSA Office; however, most individuals felt that the present staff could investigate criminal cases with a minimum of training. Based on the field interviews and the documents reviewed, the committee has concluded that no Federal agency including DOL is presently conducting a program to find ERISA criminal violations. With the emphasis on non-criminal cases in the present ERISA enforcement policy, the Committee is of the opinion that the Department is not fulfilling its responsibility under ERISA to provide a balanced enforcement program.

RECOMMENDATIONS

The Committee recommends that the enforcement policy for ERISA be completely reviewed and republished. The restatement of enforcement policy will require a major effort and should give consideration to the following:

1. The elimination of the significant case process as it is now defined.

2. The responsibilities placed upon the Department to protect the plan assets and rights of participants and beneficiaries.

3. The minimum enforcement efforts which should exist for each type of ERISA violation; not overlooking reporting and disclosure. The minimum standards for targeting of cases; audits and compliance reviews should be set as well.

4. The various types of plans; the various sizes of plans and the geographical distribution of plans. Enforcement policy in a highly industrial area may differ from that in a primarily rural area.

5. The effect of decentralization of litigation should be carefully considered in formulating enforcement policy.

6. The development of an aggressive criminal violation detection and case processing program as part of the overall enforcement policy with adequate publicity of any resulting prosecutions. This portion of the policy should make provision for appropriate training of staff in the area of criminal investigations.

7. There should be a clear policy made known to the field as to what can and will be litigated. The present situation where the field is kept in the dark as to litigation policy should be eliminated.

8. The implementation of minimum enforcement standards is, of course, dependent upon the availability of enforcement resources. The Committee believes that the present enforcement resources are grossly inadequate. It is recommended that the above minimum enforcement standards be developed and that DOL then make an aggressive effort to obtain the necessary resources.

9. Serious consideration should also be given to rehiring part-time law students to supplement additional permanent staff.

C. INVESTIGATIONS

1. Case Types:

Chapter 13 of the PWBP Manual lists the following eleven (11) types of ERISA investigations:

Program Number	Type
40	Deliquent Reports
41	Deficient Reports
42	Disclosure
43	Participants Rights
44	Benefit Disputes
47	Prohibited Persons
48	Fiduciary
49	Bonding
50	Compliance Reviews
51	Termination Investigations
52	Criminal Investigations

Program 53 - Targeting, was added in 1981. The purpose of this additional program is to account for field investigative time spent in pursuing matters which could, at a later date, develop into significant cases.

2. CASE QUALITY

Track Supervisors have the primary responsibility within the PWBP management structure for the monitoring of on-going investigations. Monitoring of on-going investigations is conducted by the TS through the use of Monthly Case Reviews; ad hoc discussions with auditors/investigators on day-to-day matters that arise during the course of an investigation and through the review of memoranda, reports of interview and case related correspondence which pass over the TS desk prior to filing in the case jacket. AA's perform in a largely perfunctory capacity during the active investigative stage of case processing. The AA's involvement increases when an investigation is identified as one of atypical/significance or if the report of investigation recommends litigation. All reports of investigation are forwarded to the RA over the signature of the AA.

The DARA and the ARA were identified as having two primary functions; the qualitative review of area office referrals and providing of technical expertise to the AO when requested. After case reviews of action reports are completed, the DARA/ARA decide if the action report merits referral to OE, and if so, prepare a recommendation for the RA's signature. Generally, case reviews and the preparation of recommendation memoranda are independently done by the DARA/ARA and do not require mutual approval prior to submission to the RA. The RO recommendation is attached to the case file with the AO's recommendation and it is forwarded to OE. The RA, much like the AA, is generally not engaged in active case review except for those instances where issues raised during an investigation are deemed to be of extraordinary significance.

When the action ROI is received by OE, it is first reviewed by an analyst and then by a Regional Coordinator. Prior to the submission of the ROI to SOL, it is also reviewed by the Chief, Division of Fiduciary Standards and Investigations, and receives a final review by the Director of the Office of Enforcement.

The consensus of AO/RO interviewees is that the quality of investigations and written reports at the AO level generally range from good to very good with a small percentage of investigations and reports identified as outstanding or unacceptable. One interviewee who works in the OE speculated that 20% of all cases received by OE were returned to the field for additional work. Statistics regarding the number of cases returned by OE for additional field work and the number of cases sent back to the field for voluntary compliance were promised to the Committee but at this writing have not been made available.

Suggestions for the improvement of case quality were provided by the interviewees as follows:

- Improving expertise of auditors/investigators through intensive training on Title I of ERISA with an objective of increased understanding of those statutory provisions.
- Intensive training for auditors/investigators on report writing and investigative skills.
- Implementation of new procedures aimed at fostering closer supervision of on-going investigations by track supervisors.

Without exception all interviewees stated that the time spent on the completion of an investigation can be reduced through closer supervision of on-going cases by track supervisors. It was felt that closer supervision would result in an earlier determination concerning the decision to continue or terminate the investigation. The universal recommendation of interviewees at all levels was for the streamlining of the report required for those investigations where there were no violations or no action required. One recommendation suggested amending the PWBP manual to allow for the use of a simplified ROI format requiring no exhibits for these types of closed cases. One interviewee suggested the use of a checklist format with no exhibits. An analysis showed that the amount of time spent writing reports for cases closed with no violations was as much as the time spent writing reports for cases closed with violations.

3. QUALITY CONTROL

There exists a diverse and non-uniform procedure for the monitoring and implementation of quality control for cases. All Regions use the PWBP Quality Standards Checklist but comments from interviewees questioned the value of that quality control mechanism. Some interviewees felt that the checklist lacked objectivity and that the terminology used in the checklist was undefined. Various other procedures and devices used to monitor quality control of cases are as follows:

- RO staff visits for the purpose of reviewing case files;
- Merit Pay Quality Standards;
- Tracking the return of cases from the RO to AO;
- Review of cases by AO management to determine conformity with PWBP Compliance Manual;
- Monthly case reviews by Track Supervisors with case jacket notation.

4. INVESTIGATIVE ACCOMPLISHMENTS:

Most of the offices have a manual format for the tracking of investigative accomplishments. The primary sources are the Quarterly Review and Analysis Report and the Assets Recovered and Benefits Preserved Report. Ancillary sources include the Significant Case Report Form, AO correspondence logs, various merit pay tracking systems and other reports used on a Region-by-Region basis.

The following are excerpts from the January 5, 1978 Compliance Strategy Documents:

> "Presently, the impact of our compliance efforts is not being measured in the following terms: benefits recovered; assets preserved; number of participants affected; percentage of complaints substantiated by investigation; violations found by plan characteristics (type, entity, size, funding); violations found by industry type and by geographic location, etc."
>
> "These kinds of measures are important to the National Office in justifying requests for additional resources; yet no system currently exists to provide this data on a continuing basis."

> "The National Office is currently exploring ways of modifying the FARS information system to capture some of this information. In addition, a new system will be developed to provide these essential measures of program success."

As of April 30, 1982, PWBP has not implemented any changes which will provide the information listed above as essential for measuring program success.

5. CASES REFERRED FOR CRIMINAL INVESTIGATION

This topic deals with the manner in which criminal matters are investigated and referred to the U.S. Attorney, the OIG/OC and the FBI. It also deals with the types of records, if any, which are kept on criminal referrals. Currently, the PWBP policy with respect to the investigation or the referral of matters involving Sections 664, 1027 and 1954 of Title 18 of the U.S. Criminal Code is primarily contained in Chapters 21 and 52 of the PWBP Compliance Manual. The policy does not allow an AO to conduct a criminal investigation without OE approval and establishes a highly centralized system for referring criminal or potential criminal violations to the Department of Justice and OIG/OC.

The interviews of area and regional officials indicate generally that criminal investigations are not conducted without OE approval and criminal allegations are not generally referred by the field directly to the Department of Justice or OIG/OC. Some of the field interviewees stated, however, that there have been instances where criminal allegations have been referred directly to the U.S. Attorney, FBI and/or OIG/OC.

In the instances where direct referrals have been made, the interviewees stated that this was done because it was more efficient to do so. In those instances where referrals have been made directly, field interviewees said that records are not maintained and that very rarely are they advised of the disposition of such referrals. The consensus of those interviewed was that criminal matters should be referred to the Department of Justice and OIG/OC at the lowest organizational level possible because quicker action can be taken to investigate and prosecute violators.

With respect to field recommendations to the National Office for referral of cases to the Department of Justice for criminal investigation and prosecution, area and regional officials stated that the only record they maintain is the referral transmittal memorandum which is located in a specific case file. The field interviewees said that they are informed of a National Office referral to the Department of Justice by receipt of a copy of the

National Office's transmittal memorandum/letter to the Justice Department. Field interviewees stated that they are seldom, if ever, advised of the final outcome of cases referred to the Department of Justice.

Concerning violations or potential violations of Title 18 of the U.S. Criminal Code which are referred by the National Office to the Department of Justice, it has been determined that OE maintains a referral file which contains, in chronological order, memoranda/letters which transmitted such violations to the Department of Justice. OE also places a copy of the letter/memorandum which transmits violations to the Department of Justice in specific case files. OE is seldom informed by the Department of Justice of the disposition of violations or potential violations referred to them.

The file was reviewed and it was found that in calendar years 1980, 1981 and 1982 to date, the Department of Justice was notified in 24 cases that potential criminal violations had been detected in cases investigated by PWBP. The file contained no information as to what action the Department of Justice took in the cases; whether they were referred to the FBI for investigation or whether prosecution ever took place. Copies of these transmittal memoranda are being retained as exhibits.

6. STATUTE OF LIMITATIONS:

Generally, there has been no systematic tracking of the Statute of Limitations on civil and criminal cases. The consensus of interviewees was that the tracking of the Statute of Limitations was an OE responsibility and that current tracking was done on a case-by-case basis. Two Regions stated that they are currently studying various proposals for the tracking of the Statute of Limitations and that they would implement the selected procedure in the near future. Also, the comments from some Regional personnel indicated that they do not have a clear understanding of the point in time at which the Statute of Limitations begins to toll on a potential civil or criminal violation.

7. CASE STATISTICS - FY 81:

FARS statistics show case activity in the six Regional Offices as follows:

FY 1981

	Cases RR'd by AC	Cases cc'd by RO	cc'd w/ viol	cc'd wo/ viol	Cases Sent by RO to OE	Cases Ret'd to RO by OE
PHILA	240	234	94	140	32	17
NYC	360	350	85	265	26	17
ATLANTA	401	389	124	265	21	8
CHICAGO	306	261	117	144	32	8
KC	584	530	209	321	54	23
SAN FRAN	267	237	117	120	35	20
	2178	2001	746	1255	200	93

During FY 81 the twelve (12) PWBP Regional Office Employees (ARA and DARA) processed a total of 2201 cases, 2001 of which (91%) were closed.

About 57% of these closed cases had no ERISA violations and would therefore appear to require only a minimum amount of time to review.

The 746 cases closed with violations and the 200 which were referred to OE means, on an average, that each of the 12 Regional Offices employees were required to review 79 cases during the year in addition to those cases which had no violations.

This indicates that each of the regional PWBP Managers reviewed, on an average, 6.5 cases with violations and 8.7 cases with no violations per month.

8. CASE FILE REVIEWS

The review included examination of one-hundred forty-eight closed case files located in the Office of Enforcement and five AO's covering the period January 1, 1980 to the present. Emphasis was placed on Program 48 (Fiduciary Violations) cases in which Section 406(b) violations were alleged or disclosed. A limited number of Program 50 (Compliance Reviews) and 53 (Targeting) cases were also reviewed. The case reviews concentrated on examination of the: 1) case opening predications; 2) pursuit to logical conclusion of conclusion of additional issues and leads uncovered; 4) action on potential criminal violations; 5) timeliness in completing investigations; 6) timeliness and propriety of case dispositions; and 7) supervisory review of cases.

Review of files disclosed the majority of cases being opened were based on AO analysis of the Annual Reports, Form 5500, utilizing the "Significant Case Indicators List" and locally developed criteria that have been historically found productive in targeting cases. The National Office generated analyses of Form 5500 and information contained on the IRS computer data tape have been relied on to a lesser extent. Investigations based on receipt of a complaint were generally initiated and completed by the AO within a reasonable time after opening of the case. Issues and leads identified in the case opening documents usually were pursued to a logical conclusion, and were properly reflected in action and closing Reports of Investigation. The propriety of case disposition was generally acceptable when the decision making authority was with the Area or Regional Office and the disposition involved no violation, voluntary compliance, or no action with referral to IRS. Case files in almost all instances failed to reflect action taken, if any, by the IRS or other agencies on matters referred to them. Most cases reflected evidence of review by AO Managers.

The following weaknesses and deficiencies of a serious nature involving case management, policy instruction, and treatment of substantive violations occured in cases of all offices and therefore may be indicative of chronic problems requiring attention:

a. Failure to fully develop all issues and leads uncovered by investigation.

b. Failure to properly reference and detail all issues reflected in case opening documents and uncovered by investigation in Reports of Investigation.

c. Failure to recognize and fully develop information suggestive of criminal violations.

d. Failure to either pursue evidence of criminal violations or refer it to the proper agency in a timely manner.

e. Excessively long delays of a year and a half or longer in case dispositions after referral to SOL. Failure to make timely decisions to either litigate or pursue voluntary compliance.

f. Delays of up to one year in receiving opinions and rulings from the National Office.

g. Failure to document referrals to other agencies and action taken by them in the case files.

h. Failure to consider and actively monitor the Statute of Limitations on civil and criminal violations.

The following 11 cases are cited as examples of serious deficiencies in case handling:

a. Investigation was initiated on May 8, 1980, and is still pending. it was predicated on an Area Office targeting program in which the Form 5500 indicated that in excess of 90% of plan assets were in an investment company.

   Investigation ascertained that the investment company filed a notice of bankruptcy about one month prior to commencement of the investigation. Investigation also disclosed that the investment advisor to the plan received a kickback from the bankrupt investment company for "steering clients" to limited partnership investments sold by the company. The Area Office, Regional Office, and Office of Enforcement all concurred with voluntary compliance and apparently the potential violation of Title 18 U.S.C. 664 Kickback, was missed by all review levels. The local District Attorney is now looking at the case.

b. Investigation was initiated on December 15, 1977 on the basis of a complaint filed with an Area Office concerning the non-payment of claims by the plan administrator. Investigation disclosed that the plan administrator had failed to forward the employer and employee contributions to the insurance carrier. Investigation also ascertained that there were 19 other participants involved with a total of approximately $15,000 in unpaid claims.

   Investigation disclosed that this was a potential Title 18 U.S.C. 664 violation, Embezzlement of Funds. This case was not discussed with the Department of Justice until August 1979, a delay of one and a half years.

c. Investigation was opened on July 1, 1975, referred to the Office of Enforcement on July 22, 1975 and referred to the Solicitor's Office the same month. The case was opened based on a participant complaint that employees were being terminated in order to prevent them from becoming participants [illegible] violation of ERISA. The case file indicates a telephone conversation in May, 1978 between the assigned investigator and an attorney in the Solicitor's office. The attorney advised the investigator that no action would be taken on the case until the Solicitor's Office decides on the disposition of two "easier cases". The Regional Office and Office of Enforcement file indicates that a memo was next sent to the Solicitor's Office in September 1978 requesting an opinion on the case or, if neccessary, an instruction that the Area Office conduct additional investigation. There has been no response and this case has been pending in the Solicitor's Office since July 1975, a period of six and one half years. Review of the files reflects the violations and issues to be relatively clear and a response is warranted.

d. In March 1980, a case was opened based on a complaint from a plan participant that the Plan Administrator had misappropriated in excess of $40,000 of plan funds. Investigation disclosed that a civil case was filed by the aggrieved plan participant against the Plan Administrator in April 1980. A judgment against the Plan Administrator was entered in October 1980 as a result of the civil action. Information on the embezzlement of plan funds was not referred to the Department of Justice until February 1981, a delay of almost a year.

e. This case was opened on March 2, 1978, and the file indicates no disposition in the case. Investigation was initiated based on a complaint alleging improper payments to ineligible participants and a prohibited transaction. At this time no disposition has occurred on the prohibited transaction because the trustee filed an application for an exemption on October 30, 1981, and the application is pending in the Office of Fiduciary Standards. The case file failed to reflect any evidence of supervisory review from January 3, 1979 to November 13, 1980. Either voluntary compliance or litigation should have occurred in light of the violation not withstanding the pending request for exemption. This case is four years old.

f. This case was opened on February 25, 1980, and closed on July 9, 1981. It involves the plan sponsor manipulating plan assets by failing to pay rent, failing to pay insurance premiums when due, and failing to take action to protect $90,000 in plan assets which were lost via foreclosure. The allegations were apparently received from the IRS. After referral to SOL and consistent with the SOL opinion, the case

was referred to the IRS for corrective action. In add
SOL suggested that a potential criminal violation be re
to the Department of Justice; however, the Office of
Enforcement disagreed and the case was never referred.
addition, the Area Office advised that IRS is not takin
"complete corrective action". The Office of Enforcemen
the Solicitor's Office were never informed of the fail
the IRS to take appropriate action.

The Statute of Limitations will likely prevent further
in this case.

g. Two investigations were opened on April 11, 1978 and No
5, 1980 and closed on April 4, 1981 and April 28, 1981.
were opened to determine whether fiduciary violations
primarily because of relatively minor discrepancies dis
in a DRE desk audit. All leads were not followed to the
logical conclusion in that the investigations did not de
with a deliquent contributions issue. Also, the investi
did not follow through on whether payments to a union
for lost wages and travel reimbursements were proper.
complete Report of Investigation was never made and the
was disposed of by a relatively short memo to the regi
four months of attempting to obtain voluntary complian
Area Office states in a letter to the trustees that the
Office did not check the propriety of the trustee rece
reimbursement for lost wages or travel expenses. The
asks that the trustees check on this themselves. Thoug
apparently never recognized in the investigation, this
to be a potential criminal violation of 18 U.S.C. 664
can be established that the trustee knowingly received
compensation or unauthorized expense reimbursements.

h. Six cases were opened on December 22, 1977, based on
allegations that trustees had failed to give service cr
to participants and had denied participants pension ri
On September 14, 1979, a consolidated Report of Investi
was transmitted to the Office of Enforcement through th
Regional Administrator. The transmittal memo noted tha
because of an instruction to discontinue further invest
efforts received from an attorney in the Solicitor's Of
all of the cases referenced in the report had not been
developed. The ROI reflected clearly established fidu
violations of Section 404(a)(i)(D) of the Act. A
recommendation was made that plan trustees be required
restore past service credits and pensions not only to
participants mentioned in the report but to all partic
who were similarly treated. Further, that the trustee

required to credit all participants for benefits earned during periods for which no contributions were received. The Report of Investigation was transmitted from the Office of Enforcement to the Solicitors's Office on September 26, 1979.

The Track Supervisor notified the ARA that inquiries from participants were being received and guidance was requested as to responding to them. On March 3, 1980, the ARA informed the Track Supervisor that the Solicitor decided not to litigate the cases and that the ARA assumed they would be closed administratively. Formal notification was made to PWBP on April 8, 1980 by the Solicitor that litigation would not take place and SOL recommended referral to IRS. On July 23, 1981, a draft letter to the participants was sent by the ARA to the Office of Enforcement and the Solicitor's Office for approval. On February 3, 1981, a draft letter was sent from the Region to the AO to be sent to participants in cases where the denial of benefits was due to employer deliquency in making contributions. The draft letter, to be signed by the AA, stated that it was his decision to take no further action because the enforcement policy of the agency does not provide for litigation of those matters because of limited resources. The file does not indicate whether any such letters were actually sent.

i. On June 29, 1979, a complaint was received that the total assets of a plan were loaned to the plan sponsor to pay off a bank loan. The bank was the trustee of the plan. On March 20, 1980, the case was assigned to an investigator. On August 7, 1981, (a delay of two years) a Report of Investigation was transmitted to the Office of Enforcement through the Regional Administrator. The report recommended removal of the trustees; repayment of the loan with interest; and distribution to participants. On August 25, 1981, the Solicitor's Office requested additional investigation. At that time the ARA expressed the opinion to OE that LMSA would never litigate and recommended that no further investigation be done and that voluntary compliance be pursued. On September 11, 1981, additional investigation by the SOL was initiated with subpoenas for records and depositions being approved on October 1, 1981. The file fails to reflect copies of the depositions or what, if anything, was produced in response to the subpoenas.

On February 28, 1982, OE indicated agreement to the Solicitor's Office that the case should be disposed of without litigation by sending the plan a notice letter. The file reflects no further action on the case, however, it is understood that the bank wants a letter from PWBP giving it a clean bill of health by stating that no violation occurred.

This case was initiated on [illegible], based on the complaint of a participant that a union sponsored welfare plan had made imprudent loans to the unions wholly owned building corporation for the purpose of constructing a building. Initial inquiries disclosed that the plan had not filed reports required by the Act. On October 3, 1980, a Report of Investigation was transmitted to the Regional Office setting forth evidence of party-in-interest loans in the amount of $1,500,000. The Area Office recommended the appointment of an independent trustee; reversal of the prohibited transactions; the plan made whole; and the trustees made personally liable. On November 20, 1980, the ROI was transmitted to the Office of Enforcement with a recommendation by the ARA that the transactions be reversed and the plan made whole. The other recommendations were ignored. On December 30, 1980, the Office of Enforcement recommended to the Solicitor's Office that litigation be filed to reverse the loans and that the trustee be held liable for the losses.There has been no response from SOL, however, the file shows that on November 12, 1981, the original complaintant filed a private law suit against the plan and the trustees.

The file also indicates allegations were received of possible criminal acts by the former plan administrator. There is no documentation as to referral but it is understood the matter was informally referred to the FBI.

k. The case was opened June 6, 1979, on a complaint from a fund participant. The ROI dated June 16, 1980 showed that the trustees purchased stock of the sponsor company at a price in excess of market value; that life insurance was purchased on the company President, but the beneficiary was his estate; not the plan. Also the trustee failed to keep minutes and the plan was not adequately bonded. On October 3, 1980, OE referred the case to SOL recommending litigation. On May 6, 1981, SOL replied saying: "We concur with a finding that certain ERISA violations have occurred. However, we believe the matter should be referred to IRS."

OE believed referral to IRS was inappropriate but no agreement has been reached as to a draft notice letter to date. There were no comments in the file on possible criminal violations or the Statute of Limitations.

RECOMMENDATIONS:

The Committee recommends:

1. To the maximum extent possible, criminal referrals to the Department of Justice and OIG/OC should be made at the area office level and, where this is not possible, at the regional office level.

2. The decision to conduct a criminal investigation should be made area office level with regional approval, after proper delegation received from the U.S. Attorney.

3. PWBP should develop formal systems to track the referral and disposition of criminal matters referred to the Department of Justice and OIG/OC (or other appropriate agency).

4. Statistics derived from referral and disposition of criminal matters should be included in the proposed PWBP-MIS. The performance rating system for field personnel should be revised to give credit for tangible accomplishments in both civil and criminal investigations.

5. That Reports of Investigation be streamlined where there is a finding of no violation.

6. When an opinion from SOL is received, implement a written PWBP policy for the tracking of civil and criminal statutes of limitation.

7. Training on criminal matters to increase recognition of those issues.

8. Implementation of a policy and procedures requiring the written documentation of criminal referrals.

9. Establishment of a requirement to monitor action at all levels of referrals to IRS.

10. Establishment of a written policy requiring SOL to respond to all issues raised in Reports of Investigation referred to it.

PROTECTION OF ASSETS

This topic deals with the effectiveness of PWBP's enforcement policy with spect to protecting the financial integrity of employee benefit plans and covering plan assets which are lost as a result of ERISA violations.

The PWBP Compliance Strategy Document (dated July 5, 1979)1/ indicates at when the field is investigating cases involving violations or allegations,

> "...the immediate emphasis should be placed on preventing any loss of assets which could occur in the near future unless immediate steps are taken to prevent the loss. A second order of emphasis is placed on recovering assets where the violations indicate losses due to abuse or mismanagement. A third order of emphasis is to remove the responsible plan officials and, fourth, emphasis is placed on violations which indicate criminal abuse and warrant referral to the Department of Justice for prosecution."

In order to implement PWBP's enforcement policy and maximize the efficient se of limited investigative and litigative resources, the Compliance Strategy cument (CSD) and PWBP Compliance Manual emphasize the investigations of rge plans with large amounts of assets (i.e., significant cases). Both the SD and manual call for extensive use of voluntary compliance and referral of iolations to the IRS in order to protect, preserve and recover plan assets, here violations of ERISA are uncovered. In implementing PWBP's enforcement olicy, the CSD indicates that the Department's PWBP litigation strategy is to se legal resources on cases which are considered most significant.

Although all interviews of area, regional and national office officials ndicated that voluntary compliance, IRS referral and litigation have been sed to protect and recover plan assets, some interviewees expressed serious eservations about the effectiveness of voluntary compliance and IRS referral o recover plan assets. Field officials stated that voluntary compliance to ecover plan assets is sometimes not effective because violators believe DOL ill not sue them. They also indicated that voluntary compliance letters, hich are delineated in the PWBP Manual, are weak and leave violators with the mpression that DOL is reluctant to vigorously enforce ERISA. In regard to eferring violations/violators to the IRS, almost all the field interviews ndicate that this is ineffective because the IRS usually takes no action to

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1/ The PWBP Compliance Strategy Document is currently in the process of being revised; however, a review of substantive draft revisions do not appear to alter or change the thrust of PWBP's enforcement policy with respect to the protection of plan assets.

[illegible] after being told of a violation and that very little monitoring is done of cases referred to the IRS for action.

In regard to litigation being an effective means of protecting and recovering plan assets, most but not all field interviewees stated that oft litigation is not instituted in a timely fashion and that there is a reluctance to refer cases for litigation because of the likelihood that no action will be taken. The interviewees cited a number of cases3/ where assets were not protected, or preserved or were placed in jeopardy because of DOL's failure to have a more aggressive and comprehensive litigation strategy. Frequently, the assets which are not protected or preserved and placed in jeopardy involve relatively small plans. In addition, and because cases are so infrequently litigated, some interviewees stated that they have settled cases for less than plans are monetarily entitled to since this is the best "deal" they can get for the plans.

Field interviews revealed that both manpower limitations and strict adherence to significant case guidelines have caused area offices to fail to investigate some ERISA allegations. This happens generally when the potential violations involve small numbers of participants and small amounts of plan assets. Almost all of the field interviewees said that additional manpower and modification of the significant case guidelines to encourage small plan investigations would result in a more equitable, effective and agressive enforcement effort.

In regard to statistics, if any, which are kept on the amount of assets preserved and recovered, it has been determined that each area office prepares a "PWBP Quarterly Accomplishments Report" which gives the total amount of participant benefits recovered and plan assets restored and/or preserved. The accuracy of these statistics may be questionable; however, because there is a lack of follow-up after a violator has agreed to comply with ERISA. In addition, the accomplishments report may not accurately reflect the true amounts of assets protected or benefits restored because of definitional problems. For example, if a bonding violation is uncovered and corrected, it is not clear how this is stated in the accomplishments report. Other examples of definitional problems are determining how to calculate participant benefits recovered and how the total amount of prohibited transactions which were corrected should be counted under the category of plan assets restored or preserved.

2/ The problem of the IRS not taking action on matters referred to them may be corrected in the new IRS-DOL Coordination Agreement which is currently being negotiated

3/ These cases will be summarized in another section of this report.

The [illegible] recommends the following action:

1. Establish and monitor a formal system of follow-up to insure that violators fully carry out corrective action with respect to ERISA violations.

2. Institute more litigation (including the use of consent decrees) so that violators have a perception that DOL will sue, unless they voluntarily comply.

3. Issue press releases where voluntary compliance is obtained so that the public is more aware of DOL's enforcement of ERISA.

4. Revise and strengthen the PWBP voluntary compliance letters so that violators will believe that they will be sued, if violations are not promptly corrected.

5. Clearly define the PWBP policy with respect to DOL accepting less than 100% of the amount a plan is entitled to when voluntary compliance is being pursued. It should be clarified who in DOL has the authority to determine the amount of the final settlement.

6. Amend the IRS-DOL Coordination Agreement in order to insure that the IRS takes appropriate action on all violations referred to them for disposition.

7. Consider imposing civil penalties under Section 502(i) of ERISA as a tool in protecting and recovering plan assets. In essence, this section of ERISA authorizes the Department to assess civil penalties (similar to IRS excise taxes) against all employee benefit plans which are not qualified by the IRS under the Internal Revenue Code.

8. Inform plan participants/beneficiaries of investigative findings so that they can pursue the recovery of plan assets, where voluntary compliance is unsuccessful and litigation or IRS referral is not appropriate. (Statutory authority already exists to do this).

9. Establish a tracking system so that the Department is not prevented from recovering plan assets due to the expiration of the statute of limitations.

10. Accurately gather statistics on the amount of assets preserved and recovered by clearly defining these terms. Monitor the accuracy of statistics gathered by testing their validity through periodic review.

E. INFORMATION SYSTEM

The Field Activity Reporting System (FARS) is operated by the LMSA Office of Management and is the agency's prime Management Information System (MIS). FARS reports statistical data regarding the status of cases and expenditure of investigative and supervisory time. Principal input for the system is at the AO and is prepared to coincide with DOL pay periods. The reporting and comparison of field performance against annual field Program Operational Plan goals is also accomplished through FARS.

FARS was evaluated by LMSA on at least two prior occasions. In order to put the current observations of this Committee into perspective brief excerpts from these studies are set out below.

> On November 18, 1977, the Science Management Corporation, 1730 K Street, N.W., Washington, D.C. 20006, issued a report to DOL on the Evaluation of the Delivery of LMSA Field Services.
>
> Page II-26 of the report states:
>
> - "The LMSA field staff do not believe the data compiled by FARS. The managers in the field have implemented data systems of their own."
>
> Page IV-22 of the report states:
>
> - "FARS will probably need to go through a number of additional changes in order to become an accurate, useful, reporting system."
>
> In 1979, Presidential Intern James P. Traynor submitted a FARS Evaluation Report to the Assistant Secretary. This report, among other things concluded that FARS:
>
> - was a failure because of inaccuracy, cumbersome format and long turnaround time;
> - was unsuited for operational management;
> - conveyed information back to the field about which the field already had knowledge;
> - was, in effect, replaced by manual systems in the field which were considered more reliable and timely;
> - cost between $250,000 and $500,000 annually to operate;
> - was "a primitive system", which could not integrate file information to identify problems, patterns, trends or projections; and,

The TRAYNOR Report, in part, recommended that:

- FARS be funded as a seperate organizational entity; an
- LMSA develop a system to assess the cost effectiveness of

Since these evaluations were submitted the perception of FARS has not improved.

The vast majority of interviewees, at all organizational levels, felt that FARS was not effective as a management tool and useless in ERISA enforcement. The complaints remained the same: inaccuracy, untimely, and of very limited utility because of confusing format.

The minority who used FARS said it was of some value to monitor case age, case unit times and to collect statistical data.

Every RO and AO contacted as part of this study maintains an independent and different type of manual statistical system and most of those interviewed said the cost of the manual system was minimal.

There was total agreement that LMSA needed a Management Information System and that the system should start to accumulate both quantitative and qualitative statistics on investigative results, litigative results, DOJ referrals, assets preserved and benefits restored.

RECOMMENDATIONS

The Committee recommends that:

1. FARS for PWBP should be eliminated.
2. A simplified manual statistical system applicable to cases and investigative time should be designed by field level management and, when approved, its use should be uniformly mandated for all field components with the elimination of any other manual systems now being used by the various Area Offices.
3. Top level LMSA management determine what LMSA needs from a MIS and, when designed, this new system should include both quantitative and qualitative statistics on civil and criminal investigative and litigative results in terms of assets restored, benefits protected, etc.
4. The "new" LMSA MIS should be integrated with the Program Operational Plan.

F. PLANNING

The Program Operational Plan (POP) is the annual field planning process within LMSA which allocates resources to the field, details results expected and establishes time-frames in terms of percentages of staff resources to be utilized on various investigative case types.

PWBP sends its annual field program goals to the Office of Field Operations (OFO). These goals are then sent to the RA's. The RA's typically then require the AO's to construct a POP, based on these guidelines, which are consolidated by the RA and returned to OFO as a regional POP. Performance is monitored quarterly by using FARS reports and each AO sends a Quarterly Review and Analysis (QR&A) report to the RO where they are again consolidated and sent to OFO as a Regional QR&A. Actual RO and AO performance against POP objectives is a major factor in rating field managerial/supervisory staff for merit pay purposes.

The OFO Guidance Memorandum for FY 82 was sent to the field as an attachment to LMSA Notice 27-81 dated July 31, 1981. The PWBP portion specified that:

- At least 90% of investigative time be spent on targeting of significant cases, and fiduciary investigations.
- No more than 5% of time be spent on other investigations.
- No more than 5% of time be spent on Technical Assistance.
- Thirty (30) days per completed fiduciary case was the overall PWBP objective.

The vast majority of staff interviewed said that POP was:

- useless in ERISA enforcement;
- responsible, in part, for PWBP enforcement inefficiency since it stressed quantity rather than quality;
- counterproductive since it encourages AOs to select those cases for investigation which could be expected to conform to the expected unit time;
- not a plan in any sense of the word but rather a "production schedule."

The minority who favored POP felt that it was:

- a useful tool for budget and accountability purposes;
- the only vehicle within LMSA to establish quantifiable goals and timetables.

RECOMMENDATIONS

The Committee recommends the following action:

Top LMSA Management revise the current POP process in PWBP to a planning system which will:

1. Originate at the AO level and plan from the bottom up.
2. Have more planning flexibility than now exists.
3. Be integrated with the newly proposed management information system.
4. Be a part of a new system for rating offices and field staff for merit pay purposes.

3. CASE TARGETING

As set out elsewhere in the Report, the initial step in the sele cases for review, audit and investigation should be a computer based system to process the Annual Reports submitted by the plans. Unfortuna as noted, such a system is not available and in use at present. This th raises the question as to how cases actually are developed and selected f investigation at present

The field interviews disclosed that there is no standardized system for developing cases in the field. Each Area Office has its own system. There are, of course, a number of "walk-in" complaints which are generated spontaneously outside the Department. But there are not enough of these type of cases to keep the staff busy. So each office finds ways to obtain information to open cases. The methods and techniques used vary from place to place and in general are not reduced to writing.

In some cases, the Track Supervisor depends upon memory of past events and upon a review of local newspapers for significant items affecting local companies or labor unions. In some cases, an office may request copies of 5500's from the National Office or may go to the local IRS office and review more current 5500s on file there. In some cases, field personnel go directly to the plan in their territory and ask to review the most current report.

In the local targeting system used by each office, an important consideration is whether the case developed will be compatible with the constraints placed on the office by the Program Operating Plan as to percentages of manpower for types of cases; the input time per case estimates and size of assets and number of participants. Also considered is the requirement for having at least two significant cases at all times.

The interviews indicated that at present there is no nationwide ERISA program to:

- Detect cases of willful failure to submit reports as required.
- Detect cases of willful submissions of incomplete or inaccurate reports.
- Detect cases of criminal violations, particularly of Title 18.
- Verify contributions from employers or payments to beneficiaries.
- Examine terminations, particularly plans which go bankrupt.
- Conduct audits or compliance reviews.
- Identify plan officials or fiduciaries who have criminal records which would bar them from plan management.
- Identify service providers and paid plan administrators.

The field personnel interviewed generally agreed that it would he a good idea for nationwide criteria to be established concerning the above.

RECOMMENDATIONS

The Committee recommends the following actions:

1. That PWBP implement a program for detecting deliquent and non-reporting of ERISA annual reports. This is a basic ingredient needed for enforcement purposes since reporting enforcement affects the enforcement of all other provisions of ERISA.

2. That PWBP initiate a policy to permit the AOs to set the actual targeting parameters, with the approval of the RO. The AOs advise NO/OE so that the computer may be utilized in setting out a program to furnish the necessary Form 5500 series reports to the AOs. The actual opening of cases should remain the responsibility of the AOs.

3. That PWBP form a committee of field personnel and NO/OE personnel to review the Form 5500 series in order to obtain input into any changes needed in these forms that would be necessary to make them more enforcement oriented.

4. That PWBP initiate a research project to develop a more uniform, systematic and/or scientific National Office targeting program particularly as to the various topics set out above.

H. TRAINING

Training is considered an integral and vital part of the process which assures professional performance by field investigators. Professional training must be provided by an effective mechanism. With this in mind the committee conducted interviews of various PWBP management personnel to determine: 1) the backgrounds of staff investigators/auditors; 2) their criminal investigative experience; 3) the types of cases they handle; and 4) the training responsibility, needs and records.

The results of interviews indicate that PWBP staff personnel have been hired from diverse backgrounds. These various backgrounds provide the expertise required by ERISA investigations. In general, no distinction is made between investigator and auditor in case assignment, since at the journeyman level, all are expected to handle a variety of cases. Occasionally, there are instances where an auditor may be assigned a case because of particular expertise in complex financial transactions. A wide range of opinions were expressed as to the number of PWBP staff with criminal investigative experience. However, it was determined that the majority of PWBP field personnel lacked this type of experience.

It was learned that the National Office has effectively cancelled all broad training programs; however, limited training has been provided by some regional and area offices. The present responsibility for field training is now unclear and there appears to be no organized approach to training. The reason cited for the lack of coordinated training was the abolishment of the training office/officer at the National Office due to budget constraints.

The majority of those interviewed felt there should be a formal programmed system of training for all PWBP personnel, and that this training should be given based on experience and tailored to a person's needs. Experienced personnel should not be given the basic training courses for new employees. Training should consist of: 1) basic training, report writing, interview techniques, etc.; 2) advanced training, the latest rules and regulations, technical skills, etc.; 3) update training, to be done periodically in order to insure all personnel are aware of the latest policies and procedures in PWBP; and 4) on-the-job training. There should also be a training record which will show what training a person needs, what training has been received, and the various skill abilities possessed.

Training needs identified by those interviewed were: basic skills, computer training, actuarial training, banking and trusts, class exemptions, court procedures, securities and investments, real estate, insurance, supervisory skills, and criminal investigative requirements and techniques.

RECOMMENDATIONS

The Committee recommends the following action:

1. That a written training plan be prepared, published and implemented to provide enhancement of the professional qualifications of all FWBP enforcement staff.

2. A formal training office should be established staffed with an experienced full-time professional who is capable of designing and implementing an extensive training program.

3. Training suggestions be requested from FWBP personnel in the field and specific training needs be identified.

4. Establishment of a formal comprehensive career development training program which proceeds from basics through advanced technical courses. It should include periodic updating and be tailored to the specific needs of the individual.

5. Training be provided in conducting criminal investigations, if FWBP is given a greater criminal investigative responsibility.

6. A formal permanent record system be established which will show for each individual the following:

    a. what training is needed;

    b. what training has been received; and

    c. skill abilities.

IV. RELATIONSHIPS WITH THE SOLICITOR AND OTHER AGENCIES

A. Cases Referred to the Solicitor

The DOL Solicitor's Office responsible for ERISA litigation is the Plan Benefit Security Division. A litigation status report was reviewed and shows that from September 2, 1974 thru March 31, 1981 the Secretary acted as plaintiff in fifty-eight (58) cases, excluding Teamster Central States litigation. Thus, on average, less than 9 cases a year were filed in court by DOL during the first 6 1/2 years of ERISA's existence. The number of actual trials is unknown, however, it is believed to be very small.

The field interviews disclosed that while there is no standard method in use in the field to track cases referred to the Solicitor's Office for litigation, each office has apparently designed its own system. Some systems are based on copies of referral letters; some are based on memoranda; some on color coded case file jackets, etc. Field personnel interviewed generally felt the systems devised in the field to follow action by the Solicitor's Office were adequate.

The interviews showed that it was believed that the Area Offices did have the opportunity to express their views as to how cases should be disposed of to the Regional Offices; in turn, the views of the Regional Office were adequately expressed to OE. However, the majority of those interviewed felt that the views of the field, both Area Office and Regional Office were not considered by the Solicitor's Office.

Comments from the field in five out of the six Regional Offices expressed displeasure with the relationship between the field and the Solicitor's Office. The complaints voiced were:

- excessive delay (2 to 3 years) before a decision was made on litigation.
- self serving or illogical reasons given by SOL for refusal to litigate.
- SOL was only interested in establishing procedures or new case law and not in litigating individual cases to protect plan assets or participant rights.
- SOL intervened in on-going cases and negotiated settlements unilaterally without consultation with PWBP.

- Investigators were frustrated when long periods of time were spent working on a case only to have the Solicitor show no interest in litigation.

- Litigation was believed to be effective when used but Solicitor litigated too few cases.

- The Solicitor's Office had no interest in litigating reporting violations.

- The Solicitors Office failed to furnish guidence on applicabiltiy of Statute of Limitations.

The individual case file reviews reported elsewhere indicate an occasional intrusion by SOL in investigations and in program decision making.

It was clear from the interviews that as far as the field was concerned, decisions made by the Solicitor's Office as to non-litigation were final and were not subject to appeal. A number of suggestions were received that if litigation is decentralized; LMSA personnel (the Regional Administrator or otherwise) should have the authority to make the final decision to litigate; to refer to IRS; to seek voluntary compliance and to set the terms of settlement.

It was also indicated that discussion has taken place within LMSA recently regarding attorney-client relationships between the Solicitor's Office and LMSA and the fact that responsibility for program decisions lies within LMSA; not within the Solicitor's Office. The interviewees indicated a wait and see attitude as to whether a true attorney-client relationship will be established between PWBP and SOL.

Recommendations

The committee recommends the following actions:

1. litigation decisions be made by LMSA personnel responsible for PWBP, with the advice and counsel of SOL.

2. a more aggressive enforcement posture be adopted by LMSA/SOL as to:

    a) number of cases litigated

    b) types of cases litigated

    c) remedies sought.

3. significant staff increases be sought in the Office of SOL to minimize delays and maximize litigation.

4. better communications be developed between SOL and the field to facilitate: discussion of issues involved in cases, exchange of views and recommendations on cases, final decisions as to disposition of cases.

5. a true attorney-client relationship be developed with adherence to the proper reponsibilities of each and non-intervention in the responsibilities of the other.

B. DECENTRALIZATION OF LITIGATION

Interviews were conducted by the committee of area, regional, and National Office personnel regarding the topic of Decentralization of Litigation. These interviews concentrated on: 1) the general proposal to decentralize litigation, 2) the advantages and disadvantages of decentralization, 3) the field's role in decentralized litigation, and 4) the role of the Office of Enforcement (OE).

Responses to the Committee's questions in these areas indicate the following:

> Decentralizing litigation is necessary to improve the effectiveness of the PWBP program provided that enough specialized attorneys are provided and used. The advantages cited are: 1) more cases will be litigated, 2) prompt disposition of cases, 3) closer relationship between enforcement and legal functions, 4) greater familiarity with the cases, 5) ability to have attorneys serve as advisors in other ERISA legal matters, 6) more input by AO and RO personnel regarding litigation and 7) facilitation and promotion of voluntary compliance because litigation would be a real threat.
>
> Cited disadvantages are: 1) possible uniformity problems, 2) possible use of "generalist" lawyers instead of ERISA specialists, 3) Regional SOL may not have sufficient attorney resources, and 4) possible litigation of "poor" cases due to lack of local expertise.

The consensus was that in decentralized litigation, the field would play a much greater role as to decisions made, whereas in the past only recommendations had been made. Regional and Area Offices would be comfortable making enforcement decisions if authority was delegated to them. The handling of criminal issues would be facilitated by decentralization of ERISA litigation, with referrals being made on regional and local levels. Recommendations for the role of OE in a decentralized litigation system include: 1) assist in the formation of a National enforcement policy, 2) provide technical advice, 3) provide a source for national training, 4) insure uniformity of issue treatment, 5) provide liaison with other agencies and other N.O. components, 6) maintain the manual, 7) develop information (intelligence) systems, 8) provide targeting functions, and 9) provide case quality control after the fact.

The responses indicated that with decentralization of litigation, there was no need for the current OE technical case review role, but that OE could effectively serve the field in these other capacities.

RECOMMENDATIONS

The Committee recommends the following actions:

1. Decentralize ERISA litigation by October 1, 1982.

2. Litigative decisions be made by PWBP personnel after consultation with SOL. A majority of these litigative decisions should be made in the field.

C. RELATIONSHIP WITH OTHER AGENCIES

PWBP/LMSE

The personal relationship between PWBP and LMSE is good; however, the working relationship is poor. No real cross track awareness exists between the two groups. There is very little formal or informal contact between the two and each seem to be doing their own thing with little concern for the other.

Very little information is exchanged between the two and neither group is certain whether its investigators review the others indices (which are separated in most instances) in the course of case opening at the area office.

PWBP/IRS

Relationship between PWBP and IRS ranges from very good to proper but distant. Generally, the flow of information is one way, PWBP to IRS with little in return. When PWBP refers party-in-interest and self-dealing transactions to IRS, there is rarely any feedback on disposition. Some complaints were raised concerning IRS not imposing excise tax which would enhance LMSA enforcement. All believe the one way flow of information is due to disclosure restrictions imposed on IRS.

PWBP/FBI

Relationship between PWBP and the FBI range from non-existent to good on an agent-to-agent basis. Most interviewees reported the flow of information is one way with little information coming from the FBI which causes strained relationships. Information provided to the FBI is on a request basis and rarely a routine referral.

PWBP/OIG

Relationship between these two offices are described as from cordial but distant to "not good" by LMSA personnel. OIG personnel complain that they mistrust LMSA personnel and felt there was a lot of hostility towards OIG because the Strike Force responsibility once rested with LMSA. There was a consensus from both parties that a lot of the resentment was caused by personalities and the fact that some LMSA personnel transferred to OIG. Very little information is provided by either party and very few referrals have been made. LMSA personnel complained that OIG was not living up to its part of the Memorandum of Understanding since they had received only one list of OIG targets and the memorandum requires a quarterly list. OIG personnel complained that the case opening notices provided by LMSA as a result of the memorandum contain no predication and sufficient data to identify violations.

There were also complaints by some LMSA personnel that OIG should come up with a definition of "organized crime" that LMSA could endorse. One regional office has instituted a written policy which requires OIG to request in writing copies of file documents or review of same at the area office. While this does not seem unreasonable, the OIG official in the region affected has to request copies of LM Reports and wait for regional approval. Conflicts have occured when identical targets were subpoenaed by both OIG and PWBP.

RECOMMENDATIONS

The Committee recommends the following actions:

1. Integrate PWBP and LMSE indices in all offices. Training sessions should be conducted and include sufficient training to improve cross track awarenes.

2. Review and revise the LMSA/IRS agreement to assist LMSA in its enforcement efforts and include the requirement that scheduled formal meetings between area office personnel and IRS counterparts be held periodically with agenda input preceeding each meeting. By joint regulations issued by officials of PWBP and IRS, require plans to file a copy of Form 5500 with the Department of Labor.

3. Scheduled meetings should be held between area office personnel and their field counterparts of the FBI. Scheduled meetings should be held on a regular basis between National Office personnel and the FBI Headquarters staff to encourage more cooperation between the agencies in the enforcement of ERISA.

4. Set up a National Office LMSA/OIG work group with access by LMSA Area Offices, Regional Offices, and OIG/Organized Crime Special Agents-in-Charge so issues can be dealt with before they create more serious problems. A working definition of "Organized Crime" should be developed by the work group so as to make referrals and cooperation more effective.

   A uniform policy directive setting forth the exchange of file information at the area office level should be issued. Where copies are necessary, a simple easy to complete form should be devised to reflect what was copied are required. The directive must set forth the restrictions imposed on OIG relative to Rule 6(e) of the Federal Rules of Criminal Procedure, but should provide that OIG will provide non-Grand Jury information and non-Organized crime complaints which come under LMSA's enforcement responsibility in LMRDA and ERISA. The work group described above can monitor and be available to resolve complaints.

It is further recommended that a Secretary's Order be issued requiring mutual support and the coordination of efforts between PWBP and OIG/OC as a matter of policy in a unified Departmental effort to eliminate corruption in the Pension/Welfare Plan field. The policy should require the direct referral of information and allegations within the programatic jurisdiction of either agency. It is further recommended that formal meetings be held at least on a quarterly basis, and more frequently if desired between field offices of both agencies.

ANNUAL ERISA REPORTS:

As indicated earlier, DOL does not have exact figures as to the number of covered benefit plans required to submit annual reports, but it is well over a half a million. It is obvious that DOL with its limited resources cannot individually audit, review or monitor the activities of each of these plans to exercise the oversight responsibility imposed upon DOL by Congress. A review of the administrative and financial information in the Annual Reports filed by the plans thus becomes one of the most important tools available to DOL to fulfill its mission. Again it is obvious that the review of hundreds of thousands of complicated annual reports is not a task for a completely manual operation. It is a task which should utilize to the maximum practical limit the electronic data processing equipment now available. The computers should be programmed to select or "target" certain plans for review, audit or investigation based on the information in the annual report.

Again as indicated earlier, the computerized review of the Annual Reports has been for all practical purposes non-existent. The interviews conducted by the Committee and the documentation collected showed that a number of serious problems exist in this area and, unfortunately, it does not appear at this time that much movement is taking place in the direction of a solution to these problems.

The first problem concerns the paperwork flow involved with the handling of the Annual Report itself. The Annual Report is known as Form 5500. It is required to be submitted within seven months after the close of the plan year but plans may apply for and receive extensions of the filing period.

The Annual Reports are mailed by the plans to IRS Service Centers throughout the country. IRS staff review the reports using a check list to determine if all required data is on the form. If an item is missing, IRS sends a letter to the plan requesting the data but proceeds to process the Annual Report without waiting for it. Processing consists of key punching a large part but not all of the data on the form into a computer tape. After the key punching, the Form 5500 is sent to a DOL Contractor where it is duplicated on microfiche. The Form 5500 is returned to IRS and the microfiche duplicate goes to DOL for the Public Disclosure Room.

DOL receives the magnetic tape containing the information keypunched by IRS from the Form 5500. The tapes received from IRS are not edited; they may contain data from Form 5500 Annual Reports for different years; they may contain amended or duplicate reports.

DOL has had and continues to have great difficulty in using these tapes for targeting purposes. The reasons for these difficulties are not quite clear. However, one thing does stand out. DOL has no program to detect deliquent reports; that is, the failure of a plan to submit a report. The reporting requirements have been in place since 1975 but DOL still has not established a Master File identifying plans which are required to report under ERISA. An effort several years ago by DOL in this area ended in failure as reported by the General Accounting Office when DOL sent notices of deliquency to several hundred thousand plans, most of which had, in fact, submitted reports. No further efforts have been made by DOL in this direction. Nor is the IRS making any effort to identify non-filers according to information received by the Committee. However, a serious question can be raised as to how DOL can be expected to enforce the other provisions of ERISA if it cannot enforce the basic requirement on plans to file Annual Reports.

As said above, DOL seems to have difficulty coping with the data actually received from IRS. Representations have been made that the way to solve this problem is to have the Annual Reports delivered to DOL and give DOL the responsibility for key punching the data into the computer tapes. A statement made in support for this move is that there are long delays before the data on the Annual Reports becomes available for use by DOL. The Committee has not verified in detail why this occurs but it is known that the last major targeting run attempted within DOL was on March 5, 1981 and this run was made on the data from 1976 Annual Reports.

It is of interest to note what happened. The OE National Office has developed a list of 12 Significant Indicators of possible violations based upon answers to questions in the Annual Reports. These significant indicators include such items as:

Benefits Reduced
Inability to pay benefits
Party-in-interest investments and transactions
Non cash contributions
Loans and leases in default
Bonding Loss etc.

When this program was run against some 40,000 pension plans with over 100 participants, over 14,000 possible violations were noted. Other runs were made on welfare plans and pension plans with less than 100 participants. However, when the results of this targeting run were sent to the field, they were rejected almost totally by the field on the grounds that the information was three or more years old. To be useful to the field, therefore, the information from targeting runs must be more current.

The interviews with the field personnel were almost unanimous in indicating that the field would like to have targeting runs on the data in the Annual Reports but they would like to have this on a more current basis. The field generally believed that the blame for the lack of current information from Annual Reports was attributable to IRS delay.

The field personnel also indicated generally that they believed that the format of the Annual Report Form 5500 should be expanded to provide more information. While little in the way of specific suggestions as to additional data requirements was received, it was suggested that field personnel participate in any review process to change the 5500 format.

In summary, then, the inquiries as to Annual Report targeting show that some major organizational problems must be solved before a truly efficient targeting system based on the annual reports can be effectively in place.

RECOMMENDATIONS:

The Committee recommends the following:

1. The responsibilities for the design, implementation and management of data processing systems for ERISA enforcement should be refined and clarified. At present, it appears there are two groups involved; the Office of Reports and Disclosure, PWBP and the Office of Management, LMSA.

2. A Master File for Plans Required to Report should be designed and implemented. When this is done, then a program should be designed and implemented to detect plans which have failed to submit Annual Reports.

3. A program using significant indicators or a similar technique should be designed and implemented to review Annual Reports for targeting purposes.

4. If and when the above recommendations are accomplished; this will mean that extensive lists will be coming out of the computer for such matters as:

   Lists of plans which may be two or more years deliquent in filing reports.

   Lists of plans whose annual reports have omitted significant information.

   List of plans identified as having problems or potential violations such as party-in-interest transactions or investments; non-cash contributions, loans and leases in default, etc.

For the targeting mechanism to have any value, manpower resources must be available to check out a proper number of these plans. It must be remembered the use of computers is only a technique that leads to actual investigation; the computer runs are not finished products. If adequate resources are not available to do what should be done to sift through the lists and select the best candidates for investigation; then there is no point in going through the data processing exercise.

VI. EXHIBITS AVAILABLE

1. EMPLOYEE RETIREMENT INCOME SECURITY ACT
2. TITLE 18, UNITED STATES CODE SECTIONS 664, 1027 and 1954
3. MEMORANDUM OF UNDERSTANDING BETWEEN DOL AND DOJ, DATED FEBRUARY 1975
4. SECRETARY'S ORDER 13-76
   DELEGATION OF AUTHORITY AND ASSIGNMENT OF RESPONSIBILITY FOR ERISA
5. ERISA 1978 AND 1979 REPORTS TO CONGRESS
6. ERISA 1980 DRAFT REPORT TO CONGRESS
7. PRIOR PLANS FOR REVIEW OF LMSA
8. FEDERAL TIMES ARTICLE OF MARCH 8, 1982 RE: SOL
9. PWBP COMPLIANCE MANUAL
10. NOTES FROM INITIAL OIG/LMSA MEETING ON MARCH 11, 1982
11. LMSA BACKGROUND MATERIAL OBTAINED BY BOSTON IG
12. COPY OF DRAFT TOPICS DOCUMENT
13. DRAFT WORKPLAN PREPARED BY TASK FORCE
14. FIELD INTERVIEW QUESTIONNAIRE
15. NATIONAL OFFICE INTERVIEW QUESTIONNAIRE
16. REPORT OF INVESTGATION CHECK LIST
17. TASK FORCE TEAM ASSIGNMENTS
18. TASK FORCE TEAM SCHEDULES
19. ASSISTANT SECRETARY DOTSON LETTER, DATED MARCH 16, 1982, TO EXECUTIVE STAFF RE: TASK FORCE
20. LISTING OF LMSA AREA OFFICES
21. OFFICE OF ENFORCEMENT DIRECTORY
22. PWBP DIRECTORY, FEBRUARY 1982

23. PWBP ORGANIZATIONAL CHARTS
NATIONAL OFFICE, REGIONAL AND AREA OFFICES

24. PWBP MILESTONE CODES

25. POSITION DESCRIPTION, PERFORMANCE STANDARDS AND MISSION STATEMENT FOR ASSISTANT ADMINISTRATOR FOR FIELD OPERATIONS

26. POSITION DESCRIPTION, PERFORMANCE STANDARDS FOR NATIONAL OFFICE ENFORCEMENT STAFF

27. POSITION DESCRIPTION FOR REGIONAL AND AREA OFFICE ENFORCEMENT STAFF.

28. OFFICE OF FIELD OPERATIONS MISSION STATEMENT

29. PWBP MISSION STATEMENT

30. PWBP MERIT PAY STANDARDS

31. PWBP COMPLIANCE STRATEGY DOCUMENTS DATED JANUARY 5, 1978 AND JULY 5, 1979

32. PERFORMANCE STANDARDS: REGIONAL ADMINISTRATORS
PWBP/ARA
PWBP/DARA
AREA ADMINISTRATORS
TRACK SUPERVISORS
UNIT EMPLOYEES

33. BUDGET REQUESTS, FY 80 AND FY 81, BY AUTHORIZING LEGISLATION

34. OFFICE OF THE SOLICITOR, ORGANIZATION CHART AND MISSION STATEMENT

35. ANALYSIS OF TARGETING GUIDE 1978 5500 REPORTS

36. FARS EVALUATION BY JAMES P. TRAYNOR

37. REPORT OF SCIENCE MANAGEMENT CORPORATION ON THE DELIVERY OF LMSA FIELD SERVICES DATED NOVEMBER 18, 1977

38. PAGES 15-18 OF FIDUCIARY TRAINING MANUAL RE: SECTION 406 AND 407 TRANSACTIONS

39. LISTING OF 100 FIELD STAFF WITH CRIMINAL INVESTIGATIVE EXPERIENCE

40. DATA RE: 24 CASES WITH CRIMINAL POTENTIAL REFERRED TO DOJ IN 1980 AND 1981

41. OFFICE OF ENFORCEMENT MATERIAL RE: DOJ REFERRALS

42. LMSA NOTICE 45-78 PROCESSING OF ROI AND MISCELLANEOUS MATTERS

43. HISTORY OF PWBP STAFFING CEILING

44. CASES REFERRED TO FIELD BY OE FOR VOLUNTARY COMPLIANCE

45. ANALYSIS OF CLOSED (NO VIOLATION) CASES PER FARS FOR FY 81

46. LISTING OF LITIGATED CASES THRU MARCH 31, 1981

47. CASES IN PBSD AS OF APRIL 15, 1982

48. MEMO FROM GIEBEL DATED MARCH 31, 1982, RE: REQUEST FOR DELINQUENT REPORTS INVESTIGATIONS DATA

49. MEMO FROM GERMAN DATED APRIL 13, 1982, RE: ERISA PLAN UNIVERSE AND IRS DATA

50. MEMORANDUM FROM LANOFF, DATED OCTOBER 23, 1981, RE: ANNUAL REGIONAL APPRAISALS FOR FY 81

51. STATISTICAL REPRESENTATION OF CASEWORK IN FY 80 AND 81

52. MEMORANDUM FROM MONICA GALLAGHER, DATED APRIL 15, 1982, RE: STATUE OF LIMITATIONS

53. SIGNIFICANT CASE SUMMARIES FOR OCTOBER, 1981

TED STEVENS, ALASKA
CHARLES McC. MATHIAS, JR., MARYLAND
WILLIAM S. COHEN, MAINE
DAVID DURENBERGER, MINNESOTA
WARREN B. RUDMAN, NEW HAMPSHIRE
THAD COCHRAN, MISSISSIPPI

THOMAS F. EAGLETON, MISSOURI
LAWTON CHILES, FLORIDA
SAM NUNN, GEORGIA
JOHN GLENN, OHIO
CARL LEVIN, MICHIGAN
ALBERT GORE, JR., TENNESSEE

JOHN M. DUNCAN, STAFF DIRECTOR
MARGARET P. CRENSHAW, MINORITY STAFF DIRECTOR

WILLIAM S. COHEN, MAINE, CHAIRMAN

WARREN B. RUDMAN, NEW HAMPSHIRE
DAVID DURENBERGER, MINNESOTA

CARL LEVIN, MICHIGAN
LAWTON CHILES, FLORIDA

SUSAN M. COLLINS, STAFF DIRECTOR

United States Senate
COMMITTEE ON
GOVERNMENTAL AFFAIRS
SUBCOMMITTEE ON
OVERSIGHT OF GOVERNMENT MANAGEMENT
WASHINGTON, DC 20510

May 8, 1985

The Honorable William E. Brock
Secretary of Labor
United States Department of Labor
200 Constitution Avenue, N.W.
Washington, D.C. 20210

Dear Mr. Secretary:

The Senate Subcommittee on Oversight of Government Management is examining the Department of Labor's implementation of its responsibilities under the Employee Retirement Income Security Act of 1974 (ERISA) with regard to pension plans. The Subcommittee's investigation includes a review of the Department's civil and criminal enforcement efforts, the exemption process, and its implementation of the reporting and disclosure requirements under Title I of ERISA.

In order to assist the Subcommittee in its examination of these issues, I request that you or the appropriate official provide me with the following information:

(1) Please provide the following statistics for both multi-employer and single-employer pension plans for each year, 1980-84:

  (a) the number of pension plans with 100 or more participants;

  (b) the number of pension plans with fewer than 100 participants;

  (c) the number of participants and beneficiaries of pension plans;

(d) the number of pension plans terminated, amount of assets held by terminated plans, and the number of pension plans formed in each year; and

(e) the amount of assets held by pension plans.

(2) Please provide the following staff and budget statistics for each fiscal year 1980-85:

(a) the number of staff and budgeted staff ceiling in the Office of Pension and Welfare Benefit Plans (OPWBP) national office, with a breakdown according to function (e.g., investigators, auditors, exemption processors);

(b) the number of staff and budgeted staff ceiling in the OPWBP regional and field offices, broken down according to function; and

(c) the Department of Labor and Administration budget requests and actual expenditures for the OPWBP.

(3) Please provide the following statistics on the OPWBP's workload for each year, 1980-84, and estimates for 1985 and 1986.

(a) the number of pending and completed field investigations and plan reviews;

(b) the number of pending and closed criminal investigations, and the number of criminal investigations resulting in indictments and convictions;

(c) the number of pending and completed civil investigations;

(d) the number of pending and completed fiduciary investigations;

(e) for (a) through (d), the number of cases closed with results, without results, and a breakdown of the types of actions taken in cases closed with results (e.g., assets restored, fiduciary removed); and

(f) the amount of assets restored for closed cases.

(4) Please provide the following statistics on the workload of the OPWBP for each year 1980-84 and year-to-date in 1985:

(a) the number of individual and class exemption applications filed pursuant to section 408 of ERISA;

(b) the number of exemptions requested, granted, denied, and pending at year-end;

(c) the number of advisory opinions, information letters, and determinations issued by the OPWBP;

(d) the number of inquiries received and answered by the national and field offices of the OPWBP; and

(e) the number of form 5500 series reports received and processed by the OPWBP.

I ask that you provide me with your response no later than Monday, June 3. Please have your response delivered to the Subcommittee on Oversight of Government Management in room 326 of the Dirksen Senate Office Building. If you have any questions, please have your staff contact Mary Gerwin or Kim Corthell of the Subcommittee staff at 224-5538.

Thank you for your assistance to the Subcommittee.

With best wishes, I am

Sincerely,

Bill Cohen

William S. Cohen
Chairman

WSC:mbg

U.S. DEPARTMENT OF LABOR
SECRETARY OF LABOR
WASHINGTON, D.C.

June 3, 1985

Honorable William S. Cohen
Chairman, Subcommittee on Oversight
of Government Management
Committee on Governmental Affairs
United States Senate
Washington, D.C. 20510

Dear Mr. Chairman:

Thank you for your letter of May 8, 1985 in which you request information to assist your committee in implementing its oversight responsibilities of Title I of the Employee Retirement Income Security Act of 1974 (ERISA). The enclosed tables provide the information you have requested. We have noted the question(s) to which the appropriate table responds in the upper right-hand corner.

What is not reflected in the tables is that during the period covered by your inquiry the Department has engaged in a significant reorganization of our ERISA responsibilities. Effective January 20, 1984 the Office of Pension and Welfare Benefit Programs (OPWBP) was created as a separate agency reporting directly to the Secretary. I would also note that the responses to certain of the enforcement related activities do not contain a complete historical breakdown. Systems to retain records in the requested detail have been operational only in the more recent fiscal years. Finally, with respect to that part of question 1(d) which requests the amount of assets held by terminated plans, neither this agency, the Pension Benefit Guaranty Corporation, nor the Internal Revenue Service has reliable data that can be provided.

I trust the information provided will be useful in carrying out your important responsibilities. Of course, my office and the staff of OPWBP would be available to provide any clarification necessary or provide further information as needed.

Very truly yours,

WILLIAM E. BROCK

Enclosures

WEB:amr

Number of Private Pension Plans and Participants, 1980-1984

	Total Plans			Single Employer Plans			Multiemployer Plans		
	Total	Under 100 participants	100 or more participants	Total	Under 100 participants	100 or more participants	Total	Under 100 participants	100 or more participants
					Plans				
1980	589,892	552,038	37,854	587,133	551,733	35,400	2,759	306	2,453
1981	663,660	623,413	40,247	660,827	623,133	37,694	2,833	280	2,553
1982	729,029	686,784	42,245	725,990	686,413	39,577	3,039	371	2,668
1983	771,538	728,332	43,206	768,439	727,952	40,487	3,099	380	2,719
1984	788,452	745,088	43,364	785,335	744,703	40,632	3,117	385	2,732
					Participants (000's)				
1980	57,903	5,743	52,160	48,910	5,726	43,184	8,993	17	8,976
1981	60,599	6,302	54,297	51,373	6,287	45,087	9,225	15	9,210
1982	63,096	6,468	56,628	53,999	6,452	47,547	9,097	16	9,081
1983	64,526	6,846	57,680	55,265	6,830	48,435	9,261	16	9,245
1984	64,529	6,855	57,674	55,361	6,839	48,522	9,168	16	9,152

Source: Data for 1980-1982 based on Form 5500 annual financial reports. Data for years 1983-1984 based on projected estimates.

Note: Data excludes Keogh plans for the self-employed.

Response to Question 1(d)

Pension Plan Formations and Terminations, 1980-1984

	Plan Formations			Plan Terminations		
	Total	Defined Benefit	Defined Contribution	Total	Defined Benefit	Defined Contribution
1980	69,342	18,849	50,493	13,279	4,297	8,982
1981	81,537	23,789	57,748	13,442	4,536	8,906
1982	85,351	28,189	57,162	15,151	5,043	10,108
1983	64,219	22,130	42,089	18,647	7,230	11,417
1984	41,086	12,807	28,279	20,172	9,153	11,019

Source: Internal Revenue Service tables on Employee Benefit Plan Determination Letters Issued 1980-1984.

Private Pension Plan Assets, 1980-1984
(Numbers in billions)

	Total	Single Employer Plans	Multiemployer Plans
1980	$664.3	$607.7	$56.6
1981	711.2	651.0	60.2
1982	861.4	788.2	73.2
1983	1,002.3	917.0	85.3
1984	1,051.8	963.1	88.7

Source: Data for 1980-1981 based on Form 5500 annual financial reports and on Pension Facts published by the American Council of Life Insurance. Data for years 1982-1984 are projected estimates.

Response to Question 2

OFFICE OF PENSION AND WELFARE BENEFIT PROGRAMS

STAFFING

(FTP Only)	1980 Ceiling	1980 Actual	1981 Ceiling	1981 Actual	1982 Ceiling	1982 Actual	1983 Ceiling	1983 Actual	1984 Ceiling	1984 Actual	1985 Ceiling	1985 Actual
(2)a. NATIONAL OFFICE												
Regulations/Interpretations [1]	54	48	46	41	38	39	37	34	31	30	27	
Exemptions	45	27	35	30	29	27	27	25	25	25	28	
Investigators/Auditors	42	45	40	37	29	32	30	25	30	25	35	
Policy, Research, Evaluation	18	15	17	17	16	18	14	16	14	12	17	
Reports and Disclosure	72	82	60	80	49	58	49	59	47	57	49	
Program Administration	12	10	10	9	9	8	9	7	9	12	10	
Other	29 [2]	28	22 [2]	21	24 [2]	25	18 [2]	18	18 [2]	22	54 [3]	
Total N.O.	272	255	230	235	194	207	184	184	174	183	220	

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[1] Includes regulations, class exemptions, advisory opinions, information letters.
[2] Includes technical assistance, inquiries, public information.
[3] Includes data base management, technical assistance, inquiries and public information, management support.

OFFICE OF PENSION AND WELFARE BENEFIT PROGRAMS

STAFFING

(2)b. FIELD

	1980	1981	1982	1983	1984	1985
Investigators/Auditors:						
Ceiling	220	209	194	195	218	218
Actual	196	195	188	193	195	
Other:						
Ceiling	87	78	66	81	81	48
Actual	73	72	70	71	72	

OFFICE OF PENSION AND WELFARE BENEFIT PROGRAMS

BUDGET REQUESTS DATA
($000)

		1980	1981	1982	1983	1984	1985
(2)c.	Departmental Request	$27,241	$29,540	$31,707	$30,799	$32,044	$31,465
	Administration Request	27,910	32,1[illegible]	31,199	27,813	29,673	29,299
	Congressional Appropriation	30,242	29,851	27,217	27,498	28,963	29,173
	Actuals	28,016	28,434	25,525	26,220	28,630	

Response to Question 3

OFFICE OF PENSION AND WELFARE BENEFIT PROGRAMS

Table 1. Enforcement Case Activity, FY1980--FY1986

ITEM	FY 1980	FY 1981	FY 1982	FY 1983	FY 1984	FY 1985 [2]	FY 1986 [2]
CIVIL CASES							
FIDUCIARY CASES							
PENDING END OF FY	1,039	796	1,158	1,094	1,131	1,128	
CLOSED	1,456	1,078	1,130	1,013	679	826	
OTHER CASES [1]							
PENDING END OF FY	595	790	847	1,112	1,157	1,119	
CLOSED	945	1,386	1,241	1,311	1,750	1,090	
SUBTOTAL							
PENDING END OF FY	1,634	1,586	2,005	2,206	2,288	2,247	
CLOSED	2,401	2,464	2,371	2,324	2,429	1,916	
CRIMINAL CASES							
PENDING END OF FY	4	2	16	56	72	65	
CLOSED	3	1	3	16	25	36	41
ALL CASES							
PENDING END OF FY	1,638	1,588	2,021	2,262	2,360	2,312	1,316
CLOSED	2,404	2,465	2,374	2,340	2,454	1,952	2,897

[1] INCLUDES PLAN REVIEWS.

[2] ESTIMATES.

OFFICE OF PENSION AND WELFARE BENEFIT PROGRAMS

Table 2. Enforcement Case Results FY1980--FY1985

ITEM	FY 1983	FY 1984	FY 1985 [2]
CIVIL CASES [1]			
FIDUCIARY CASES			
NO. OF CASES WITH RESULTS	451	383	450
PENDING CASES WITH INTERIM RESULTS	16	94	78
MONETARY RESULTS	$51,838,002	$93,138,839	$58,999,264
NON-MONETARY RESULTS			
BONDING & REPORTING CORRECTED	241	188	186
FIDUCIARY REMOVED	8	13	12
RECEIVER APPOINTED	3	8	6
DIVERSIFICATION CORRECTED	18	27	20
ADMINISTRATIVE PRACTICE CORRECTED	127	154	114
CASES WITH EXCISE TAX COLLECTED	12	26	44
EXCISE TAX COLLECTED	$556,060	$1,762,410	$5,450,000
NO. OF CASES WITHOUT RESULTS	562	296	376
OTHER CIVIL CASES			
NO. OF CASES WITH RESULTS	398	985	440
NON MONETARY RESULTS			
BONDING & REPORTING CORRECTED	480	1,069	916
NO. OF CASES WITHOUT RESULTS	913	765	650

	FY 1980	FY 1981	FY 1982	FY 1983	FY 1984	FY 1985 [2]
CRIMINAL CASES						
CLOSED WITH INDICTMENTS & CONVICTIONS/GUILTY PLEA	2	0	2	0	10	14

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[1] RESULTS DATA IS AVAILABLE BEGINNING IN FY 1983.

[2] ESTIMATES.

KEY FOR OPWBP, OFFICE OF ENFORCEMENT, WORKLOAD TABLE 2

Monetary Results - Includes amount of prohibited transactions reversed and plan assets restored in all types of cases through litigation and voluntary compliance. The majority of the recoveries are related to fiduciary cases, however, a small number of recoveries from other case types are included. Also included are interim results on pending cases.

Part of the FY 1984 increase in monetary results is attributable to a total of $20 million recovered in two related cases and $10 million recovered in two other related cases.

Non-Monetary Results - This category includes any non-monetary remedies taken by plans to correct violations. This total is less than the sum of the categories of results listed below because a case with more than one result is counted in each category in which corrective action was taken.

Bonding & Reporting Corrected - Represents the number of cases in which a single or a combination of bonding, reporting and disclosure violations were corrected. Examples of reporting violations are missing accountant's opinion or plan assets reported at cost instead of fair market value. Disclosure violation examples are failure to provide a summary plan description or plan documents to participants.

Fiduciary Removed - Indicates the number of cases were a fiduciary was removed from office as a result of OPWBP action.

Receiver Appointed - Indicates the number of cases in which a receiver was appointed to manage at least a portion of a plan's assets.

Diversification Corrected - Represents the cases in which OPWBP obtained diversification or a planned program to diversify the plan's assets.

Administrative Practice Corrected - Includes cases in which abusive administrative practices were corrected. Examples of these practices are: assets were not allocated to participant accounts at fair market value, contributions not directed to the correct plan, improper administrative expense allocation between a plan and a party-in-interest, e.g. a union or another related plan, and fiduciaries not paying participants their benefits when due.

Cases with Excise Tax Collected - Represents the number of cases in which prohibited transactions were substantiated, referred to the Internal Revenue Service (IRS) and an excise tax was imposed by the IRS.

Excise Tax Collected - Includes the excise tax imposed by the IRS in cases mentioned above.

Other Civil Cases - Represents cases other than fiduciary and criminal cases which were worked by OPWBP.

Fiscal Years: 1980-1985

PROHIBITED TRANSACTION EXEMPTIONS

APPLICATIONS	1980	1981	1982	1983	1984	1985[1]
FILED	622	736	879	1074	907	358
GRANTED[2]	132	145	236	279	232	150
DENIED/ WITHDRAWN	521	530	539	725	689	347
PENDING	317	378	482	552	538	399

ADVISORY OPINIONS, INFORMATION LETTERS, AND DETERMINATIONS

APPLICATIONS	1980	1981	1982	1983	1984	1985[1]
ISSUED	1061	1369	1221	1482	1586	1046

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[1] Thru April 30, 1985.

[2] Includes Class exemptions granted as follows: 1980-3; 1981-4; 1982-2; 1983-1; 1984-3; 1985-2. These Class actions resulted in the closing of 61 applications.

Response to Question 4(d)

OFFICE OF PENSION AND WELFARE BENEFIT PROGRAMS

INQUIRIES WORKLOAD STATISTICS

	1980	1981	1982	1983	1984	1985
(4)d. National Office						
Written Received	4,133	4,275	5,400	7,500	8,513	9,364 1/
Written Processed	3,952	4,275	5,237	6,764	8,656	9,521
Telephone Inquiries Received/Processed	15,000	13,954	12,000	14,000	14,500	15,950 1/
Field						
Written/Telephone/ Walk-in Inquiries Received/Processed	146,000	83,340	78,680	74,200	41,580	51,526 1/

1/ Estimated

May 17, 1985

5500 REPORTS

	RECEIVED	FILED
FY 1980	684,000	684,000
FY 1981	850,000	850,000
FY 1982	867,000	853,000
FY 1983	851,000	865,000
FY 1984	610,000	550,000
FY 1985 (to date)	707,000	593,000

PENSION FUNDS AND CORPORATE GOVERNANCE

A Report to the U.S. Department of Labor
Office of Pension and Welfare Benefit Programs

By the Investor Responsibility Research Center
June 1985

PENSION FUNDS AND CORPORATE GOVERNANCE

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This report was prepared under contract for the U.S. Department of Labor Office of Pension and Welfare Benefit Programs by the Investor Responsibility Research Center, 1319 F Street, N.W., Washington, DC 20004. Telephone: (202) 833-3727. The project manager was James E. Heard, director of IRRC's Corporate Governance Service.

The Investor Responsibility Research Center compiles and impartially analyzes information on the activities of business in society, on activities of institutional investors, on efforts to influence such activities, and on related public policies. IRRC's work is financed primarily by annual subscription fees paid by more than 170 investing institutions. The Center was founded in 1972 as an independent, not-for-profit corporation.

INTRODUCTION AND SUMMARY

Ten years after the enactment of the Employee Retirement Income Security Act, pension funds are estimated to have more than a trillion dollars in assets. The investment of a major portion of these assets in common stocks has made pension funds perhaps the largest group of shareholders of major American corporations. Pension funds now own approximately one-third of the common stocks of publicly traded corporations, and by the turn of the century they may own more than half.

The wave of hostile takeovers that has swept the economy in recent years, and the efforts of corporations to defend against hostile takeover attempts, have drawn new attention to the role that pension plans play in the corporate governance process. The size of pension fund holdings means that the actions of pension fund sponsors, trustees and managers can have a decisive impact on developments related to contests for corporate control.

Traditionally, financial intermediaries such as bank trust departments and insurance companies have taken a passive role in the corporate governance process. Most have followed the "Wall Street Rule" of supporting the management of companies in which they hold stock when issues are put to shareholders for approval. This practice was encouraged by the routine nature of most issues involving the exercise of the corporate franchise, as well as the wish to avoid offending existing and potential clients.

The issues now being raised in regard to hostile takeovers can hardly be labeled routine; they frequently involve decisions that can affect fundamental rights of shareholders to decide on matters of corporate control. These decisions are material in an economic sense; they require careful and independent consideration, and in matters involving pension fund assets subject to ERISA, the decisions must be made solely in the interest of pension fund beneficiaries.

Although there has been a recent movement away from the Wall Street Rule, it appears that many investment managers acting as ERISA fiduciaries still are reluctant to examine voting issues independently and to take actions that might offend corporate clients. In some cases this may result in voting decisions that are inconsistent with ERISA's fiduciary requirements.

Pension fund sponsors have been largely passive on voting matters, preferring to delegate responsibility to their outside investment managers. Despite their passivity on voting matters, some plan sponsors have used pension plan assets to further or to thwart efforts to change corporate control, in violation of ERISA.

The growing popularity of employee stock ownership plans creates new opportunities for abuse, particularly where the principal purpose of a plan is to erect barriers to a change in corporate control.

This report is intended to assist the Department of Labor and the Office of Pension and Welfare Benefit Programs in discharging their responsibilities to monitor the actions of ERISA fiduciaries on corporate governance issues. The report is divided into five parts:

- Part I reviews the kinds of antitakeover charter amendments that hundreds of corporations have asked shareholders to approve in response to the recent wave of hostile takeover attempts. It also summarizes the available evidence regarding the economic impact of these charter amendments.

- Part II discusses greenmail and poison pills. Unlike charter amendments, which are submitted to shareholders for approval, greenmail and poison pills are used without explicit shareholder approval. A number of efforts are underway to curb both practices, which have been widely condemned.

- Part III considers the role that institutional investors traditionally have played in the corporate governance process and how this role has changed in recent years as a result of the enactment of ERISA, the growth in pension fund assets and the emergence of hostile takeovers and takeover defenses. Part III also discusses potential conflicts of interest that may arise in voting on takeover matters.

- Part IV examines the role that pension fund sponsors, trustees and managers play in contests for corporate control and the conflicts of interest that may arise. It also discusses briefly how the use of employee stock ownership plans as a takeover defense may create conflicts of interest.

- Part V contains the report's conclusions. It recommends that the Department of Labor: (1) issue a policy statement outlining the responsibilities of ERISA fiduciaries on voting matters and on other matters related to contests for corporate control; (2) develop an up-to-date informational base about the participation of ERISA fiduciaries in the corporate governance process; (3) require that ERISA fiduciaries publicly disclose their voting policies on corporate governance matters; (4) examine whether the current practices of ERISA fiduciaries adequately protect the interests of pension plan participants and, if not, whether new arrangements should be explored to safeguard their interests.

I. ANTITAKEOVER CHARTER AMENDMENTS

The last several years have witnessed an explosion in the rate of adoption of antitakeover charter amendments by major corporations. This activity has brought antitakeover provisions to the forefront of the continuing debate over management accountability and shareholder interests. On the one hand, corporate executives are quick to argue that these so-called shark repellents are needed to protect shareholders from unscrupulous raiders. Critics, on the other hand, argue that defensive charter amendments discourage tender offers and other measures to change corporate control that are likely to benefit shareholders and that they make it difficult to oust managements that are doing a poor job.

As the debate rages, more and more companies are adopting charter amendments intended to ward off hostile offers.

Our own recent analysis indicates that as of December 1984, almost 200 of the Standard and Poor's 500 companies had adopted antitakeover charter provisions. In addition, more than 300 of these companies have the authority to issue so-called blank check preferred stock; although not itself an antitakeover device, blank check preferred stock may be used to create antitakeover devices, including "poison pill" securities.[1]

During 1984 alone, more than 250 corporations adopted antitakeover charter amendments. The number of companies adopting antitakeover charter amendments in 1985 is also likely to be quite large. To date in 1985, we have been able to identify more than 130 companies that have submitted to their stockholders antitakeover proposals and proposals involving authorization of blank check preferred stock.

Supermajority and Fair Price Proposals

Among the most common shark repellents are so-called supermajority provisions--amendments to the corporate charter to require a very high percentage of shares to approve a merger. Most state corporation laws set the minimum approval for mergers and other fundamental transactions at either one-half of the voting shares or two-thirds of the voting shares. Supermajority provisions put the approval level higher, frequently at 80 percent of the voting shares. In some cases, these provisions are designed to apply to all mergers. In other cases, they apply only to transactions opposed by the company's directors or to mergers involving shareholders who hold large blocks of stock.

"Fair price" provisions are a more recent refinement of supermajority proposals. They arose in response to protests that unrestrained supermajority rules simply entrench management. Most fair price amendments to a company's charter require a supermajority vote to approve a merger, but waive that requirement if the offeror agrees to pay all shareholders the same price. Such provisions usually stipulate that a majority (or a supermajority) of the board, unaffiliated with the offeror, may approve mergers without the need for either the fair price test or a supermajority vote. The fair price is frequently defined as the highest price the offeror paid for any of the shares it acquired in the target company during a specified period before the commencement of the tender offer. Fair price provisions are designed to discourage two-tier tender offers, in which shareholders who tender quickly in response to an offer to purchase less than all the outstanding shares in a company are paid more than the remaining shareholders later receive.

Sometimes, supermajority proposals submitted to shareholders for approval include a provision requiring that any subsequent amendment to the supermajority provision itself be approved by a supermajority, rather than the customary one-half or two-thirds of the voting shares. This is termed a "lock-in" provision. These lock-in provisions can apply to previously approved anti-takeover amendments as well as those proposed by the company.

Advocates of supermajority proposals--including the managements of corporations sponsoring the proposals, their lawyers, their proxy solicitors and their publicists--usually argue that supermajority proposals help to discourage takeovers that may be contrary to the best interests of shareholders. They also argue that fair price provisions protect unsophisticated shareholders from being paid less than fair value in a two-tier tender offer. For example, in its 1984 proxy statement, Westvaco urged shareholders to approve a fair price provision because, it said, two-tier offers "are essentially coercive and could work to the disadvantage of shareholders because they tend to force shareholders to accept the first price offered out of concern that they would be compelled, if the would-be acquirer gained control, to accept a less attractive price in a second-step merger. Under these circumstances, the board believes that appraisal rights provided by state law would be inadequate protection of shareholder rights." (Appraisal rights make it possible for shareholders to receive a higher price if they believe they have been treated unfairly.) Companies also say that the provisions encourage bidders to negotiate directly with management and the board, and that such negotiations will lead to results that are in shareholders' best interests.

Those who oppose supermajority proposals argue that they may discourage tender offers in which shareholders stand to receive a premium over market price for their shares. They also argue that supermajority proposals can entrench inferior management, intent on remaining in control, by giving a minority of shares a veto power over a tender offer favored by the holders of a majority of the stock.

Some opponents also question the need for fair price proposals as a result of recent changes in Securities and Exchange Commission rules regarding tender offers. In response to concerns about the fairness of two-tier offers and the limited amount of time that shareholders have to respond to them, the SEC in late 1982 amended its tender offer rules to require that a cash offer for less than all of the outstanding shares of a company remain open until the expiration deadline for tendering all shares, even if the cash offer is oversubscribed. The previous rule had permitted the proration period for a partial tender offer to be as short as 10 days. Thus, although the new rules do not prohibit partial tender offers in which a premium is paid for control, they do give shareholders more time to consider the advantages and disadvantages of an offer.

The limited empirical evidence available suggests that shareholders receive substantial above-market premiums in two-tier offers. According to a recent SEC study of 148 tender offers between 1981 and 1983, shareholders who are the recipients of two-tier tender offers on average fare almost as well as shareholders who receive a single offer and much better than shareholders in partial tender offers. The SEC study said: "The two-tier offer yields an average first-tier premium of 63.5 percent, virtually identical to the average uniform premium of any-or-all offers. The average second-tier premium of 47.1 percent for two-tier offers is less than the first-tier premium, but it is considerably larger than the 'implicit' second-tier premium of 18.6 percent afforded the 25 partial tender offers." The SEC study concluded that when first-tier and second-tier returns are blended, the average returns to shareholders for any-and-all offers and for two-tier offers "are very similar in magnitude," with the returns for any-and-all offers being slightly higher. The SEC's findings somewhat undercut arguments that two-tier offers do not provide fair returns to shareholders. The SEC also warned that restricting two-tier offers would deter some offers altogether, particularly those in which large companies are the targets.[2]

In 1984, the SEC's Advisory Committee on Tender Offers recommended that supermajority, fair price, and other antitakeover provisions be prohibited. The committee concluded that these charter or bylaw amendments "improperly interfere with the conduct of takeovers in a national market place."[3] As an alternative to outright prohibition, the committee recommended a requirement that supermajority provisions be adopted and periodically ratified by the same supermajority vote necessary to approve a tender offer. Thus, for example, a supermajority proposal requiring a 75 percent level of approval for a merger would have to be approved by 75 percent of the shares outstanding to take effect and then would have to receive the same level of support when resubmitted to shareholders for reconfirmation. The SEC did not endorse these advisory recommendations, and Congress has not acted to limit fair price or supermajority provisions.

Board Classification

Classification of the board is another antitakeover device that is used frequently. A classified board is usually divided into three groups, or classes, with one-third of the directors elected each year. Classification is intended to make it difficult for a raider, even with a large block of stock, to gain immediate control of a target's board.

Proponents contend that the length of time required to elect a majority of directors to a board in which only one-third of the directors are chosen each year is a strong deterrent to change-of-control efforts that may be contrary to the interests of shareholders. They also argue that board classification helps to assure continuity of the board and the company's long-range business strategies.

For example, Joy Manufacturing said in a 1984 proposal involving a classified board that it would protect shareholders from the threat of a proxy fight:

> The purpose of the by-law amendment is to discourage certain types of transactions which involve a threatened change of control of the company. In such transactions, a third party accumulates, without advance consultation with the corporation, a substantial, though not necessarily a majority, position in the stock of a corporation, and then uses its position as a substantial stockholder as leverage to obtain the implementation of its plan for the future direction of the corporation which often involves the restructuring, liquidation or sale of all or a part of the corporation. The announcement of such a plan is often accompanied by a threat that if not implemented, the third party will commence a proxy contest to obtain the election of his nominees to the board of directors. In many cases the third party purchases a large block of a corporation's stock and threatens to wage a proxy contest in the hope that the corporation will decide to repurchase the third party's shares at a substantial premium over market value so as to avoid the disruption of its business and the expenses incurred in defending against a proxy contest or other action undertaken by the third party.

Opponents of board classification believe that electing fewer than all of the directors each year increases the difficulty of holding management accountable for its actions and is contrary to the interests of shareholders. Lewis Gilbert, a long-time opponent of board classification, describes classified boards as "nothing but management's attempt at self-perpetuation. If a company's stock is selling low, there is no reason why it shouldn't be taken over. The only ones who benefit from this kind of board are management--not shareholders. There should be a democratic way to kick the rascals out all in one year if that's what is needed." Melvin Eisenberg, a professor at the University of California Law School, asserts that "ineffective management should be ousted by shareholders or by market forces. The most common market device is the takeover bid. [Classification] locks in present management and is contrary to the whole system."

Blank Check Preferred Stock

Each year many companies ask shareholders to approve the issuance of additional shares of preferred stock that have already been authorized or to authorize the creation and issuance of new types of securities. Many such requests are motivated by a desire to raise additional capital, to broaden a company's ownership base, or to enhance financial flexibility. On occasion, either the intent or the effect of these proposals may be to discourage or deter tender offers.

Blank check preferred stock derives its name from the flexibility given to management and the board to set voting, conversion and other rights of preferred stock that it chooses to issue. This discretion provides enormous flexibility, and this feature is commonly cited in favor of adopting such measures. For example, in support of a 1983 proposal to authorize a new class of preferred stock, Black & Decker made the following argument:

> The board of directors believes that the complexity of modern business financing and acquisition transactions requires greater flexibility in the company's capital structure than now exists. The preferred stock to be authorized...would be available for issuance from time to time for any proper corporate purpose. Such purposes might include, without limitation, issuance in public or private sales for cash as a means of obtaining capital for use in the company's business and operations, and issuance as part or all of the consideration required to be paid by the company for acquisitions of other business properties.

Blank check preferred stock may also serve as a potent anti-takeover weapon. If and when a company decides to issue such shares, it might place them in the hands of individuals or institutions that are supportive of management, and it might give the shares voting rights which stipulate that a tender offer cannot be approved unless a supermajority, or even all, of the shares are voted in favor of the tender offer. The potential disadvantages of stock issuance proposals, particularly those that involve preferred stock with undefined voting rights, can be considerable. In setting forth the disadvantages of such a proposal, as required by Securities and Exchange Commission rules, Becton Dickinson told its stockholders in its 1984 proxy statement:

> The power of the board of directors to issue additional shares of common stock or preferred stock...with voting or other rights which might impede or discourage a takeover attempt may make the company a less attractive takeover candidate and may deter takeover attempts not approved by the board in which shareholders might receive for some or all of their shares a substantial premium above market value at the time such takeover bid is made. Additionally, issuance of the preferred stock could result in a class of securities outstanding that will have certain preferences with respect to dividends and in liquidation over the common stock, and may enjoy certain voting rights, contingent or otherwise, in addition to that of the common stock, and could result in the dilution of the voting rights, net income per share and net book value of the common stock.

The effectiveness of using blank check preferred stock as an antitakeover device was demonstrated in 1984 when Carter Hawley Hale made use of its authority to issue blank check preferred stock in a successful takeover defense against a hostile tender offer by The Limited. The Limited launched a hostile tender offer for CHH in April 1984, proposing to merge the two companies. The CHH board determined that the bid was inadequate and began taking steps to block The Limited's move. After repurchasing 18 million of its common shares on the open market, CHH created a new class of convertible preferred stock with special voting rights and executed an agreement to sell 1 million shares of the new stock to a friendly third party, General Cinema, for $300 million. As a result of CHH's buyback and the issuance of preferred stock to General Cinema, General Cinema gained control of 37 percent of Carter Hawley Hale's voting securities. It agreed not to increase its investment in the company for seven years and to vote the preferred stock as suggested by CHH.

The New York Stock Exchange challenged Carter Hawley Hale's issuance of the new preferred. New York Stock Exchange rules require shareholder ratification for issuance of new classes of stock involving substantial dilution of the voting rights of existing stockholders. Shortly after the CHH-General Cinema agreement, the NYSE threatened to delist CHH for transferring such a large portion of its voting authority to General Cinema without shareholder approval. CHH argued that its actions were not a violation of exchange rules, but it agreed to submit the proposals for shareholder ratification. Shareholders did approve the issuance of the preferred stock, and CHH was able to fend off The Limited's hostile tender offer. The issuance of the preferred stock to General Cinema was critical to CHH's success.

As previously mentioned, more than 300 of the S&P 500 companies were authorized to issue blank check preferred stock as of December 1984. Already during 1985, more than 50 companies have asked shareholders to authorize new classes of blank check preferred stock or to increase the authorization for issuance of stock previously authorized.

Last year marked the beginning of a new trend among companies attempting to strengthen defenses against hostile takeover attempts when several major companies created "poison pill" takeover defenses. First adopted by Lenox in 1983 to fight a hostile takeover attempt by Brown-Forman Distillers, poison pills have been used by Household International, Crown Zellerbach, Owens-Illinois, Bell & Howell, Colgate-Palmolive, and, more recently, Phillips Petroleum and Rorer. The availability of previously authorized blank check preferred stock is often an important consideration in the decision to create poison pills. (See Part II for a discussion of poison pills.)

Dual Class Capitalization Plans

Dual class capitalization plans typically provide for the creation of more than one class of common stock with unequal voting rights. These plans, frequently called "Class B" stock plans, are usually adopted by companies that wish to ensure that a founding family management, or another group, will be able to maintain control of a corporation indefinitely, even if the company issues large amounts of new common stock. This objective usually is achieved by giving special or superior voting rights to a new class of stock and by imposing certain restrictions on transfer of the stock. The creation of Class B stock must be approved by the holders of existing common stock.

Creation of these dual class capitalization plans apparently is becoming increasingly popular. A 1984 survey by Merrill Lynch and Co. found that more than 50 companies have more than one class of common stock with unequal voting rights. The number of companies wishing to issue Class B stock is one of the major reasons that the New York Stock Exchange is considering a change in listing requirements that now prohibit most such arrangements. A decision by the NYSE to change its rules could serve as a green light for many listed companies to seek shareholder approval for dual class capitalization plans.

The plan approved by shareholders of Hershey Foods in October 1984 illustrates how dual class capitalization plans can be used as control devices. The Hershey Trust Co., acting as trustee for the Milton Hershey School, owns slightly more than half of Hershey's outstanding common. The Hershey plan created a second class of common stock, which has a voting power of 10 votes per share. Hershey common stock continues to have one vote per share, and the holders of common stock voting as a separate class are entitled to elect one-sixth of the board of directors. The two classes of stock vote together on all other matters including the election of five-sixths of the board. Votes to change the number of authorized shares, or votes on matters adversely affecting either class of stock, must be approved by each class of stock voting separately as well as by both classes voting together. In exchange for their diminished voting rights, common stock holders receive dividends that are 10 percent higher than the dividends paid to the class B stock.

Hershey provided its shareholders with the opportunity to exchange their common shares on a one-for-one basis for class B stock in the 45 days following the approval of the plan. Because of the structuring of the plan, however, there was little incentive for shareholders to swap their common stock for class B stock. First, to obtain the class B stock, shareholders would have had to forgo the higher dividends associated with the regular common shares. Second, the Hershey Trust announced its intention to convert enough of its shares to class B stock to ensure that it has the power to elect five-sixths of the board. Finally, class B stock is not publicly traded and must be converted into regular common in order to be sold. All class B stock issued is convertible into regular common stock on a one-for-one basis.

Other companies have structured their dual class capitalization plans in slightly different fashions. In 1984 the shareholders of Dow Jones approved a plan which, like Hershey's plan, provides for two classes of common stock to vote together on corporate matters and to vote separately on matters related to the board of directors and charter amendments adversely affecting one class of common stock. The Dow Jones plan differed, however, in the means by which the company distributed its newly created class B stock. Instead of offering the stock in exchange for shares of common stock, the company distributed one-half share of class B stock as a dividend for each outstanding share of common stock. The class B stock has 10 votes per share but is not publicly traded. Shareholders wishing to dispose of class B stock must convert it into common stock on a one-for-one basis. Class B stockholders elect two-thirds of the company's directors, and holders of common stock elect the remaining third. Because the class B common was initially issued on a pro rata basis, it did not dilute the voting rights of any stockholders at that time. Over time, however, as public stockholders sell their holdings, they will convert their class B stock into shares of common, and only the Bancroft family, which now controls the company, will hold class B stock.

When proposing the plans, most managements assert that they have embarked on a long-term growth plan and that the class B stock will give them needed flexibility to expand the company's capital base without making it vulnerable to takeover. Plans offering increased dividends in exchange for diminished voting power provide a financial incentive to draw shareholder support. In addition, many companies argue that there are special reasons that warrant shareholder support of the proposals. For example, Dow Jones said in its 1984 proxy statement that its reason for proposing a dual class capitalization plan was to ensure that voting control of the company remains with the Bancroft family, which owns about 56 percent of the company's stock. The company said that the proposal was beneficial for all shareholders because "the retention of control of the Bancroft family is the most likely means of assuring the continued independence and integrity of The Wall Street Journal and the company's other publications. In the opinion of the board, such independence and integrity have been crucial to the growth and financial success of the company over its history and will continue to be so in the future."

On the other hand, the plans may present far-reaching disadvantages to shareholders. Because in most cases the voting rights associated with class B stock are powerful enough essentially to eliminate the chance that any merger, tender offer or proxy contest could succeed without the approval of the controlling interest of the company, class B plans are virtually insurmountable shark repellents. Their very existence almost certainly assures that shareholders will be unable to realize the substantial premiums that bidders frequently offer to shareholders who are willing to tender their stock in takeover attempts opposed by incumbent management. Another disadvantage is that the decreased voting power of common stock significantly undermines the ability of shareholders to participate in the governance of the company, particularly in the election of directors. Finally, the market value of common stock might be adversely affected because of its diminished voting power.

For more than 50 years, the New York Stock Exchange has refused to list companies that issue different classes of common stock with disparate voting rights. The Exchange, however, is considering changing its listing requirements to allow listed companies to adopt dual class capitalization plans. In January 1985, a NYSE subcommittee recommended that currently listed companies not be delisted because of dual classes of common stock if the following four requirements are met:

- The dual class capitalization plan receives the approval of two-thirds of the voting shares.
- The listed company had a majority of independent directors at the time the new class of stock was approved and a majority of those directors approved the plan. If independent directors constitute less than a majority of the directors, all independent directors must approve.
- The voting power of one class is not more than 10 times the voting power of the other.
- Except for voting rights, the rights of the holders of the two classes of common stock are substantially the same.[4]

The proposed changes come at a time when the NYSE is experiencing strong competition from the National Association of Securities Dealers national over-the-counter market. Neither the NASD nor the American Stock Exchange, the NYSE's other principal competitor, has shareholder protection requirements for listed companies comparable to the NYSE's rules, although both have recently agreed to consider strengthening their shareholder protection requirements.

The NYSE subcommittee gave a number of reasons to justify its recommendations, noting that SEC regulation and the actions of independent directors provide much greater protection to shareholders than was available when the NYSE originally adopted some of its listing standards. The subcommittee noted, too, that the institutional investors that are becoming a more dominant force in the capital markets are knowledgeable and sophisticated enough to assure meaningful shareholder participation in the affairs of listed companies. Finally, the subcommittee acknowledged that today's competitive listing environment and the apprehensions among top executives of listed companies regarding hostile tender offers were yet another consideration in its decision.

But one former NYSE board member, John C. Whitehead, the recently retired co-chairman of Goldman, Sachs & Co., told The Washington Post in an interview, "I think the one-share, one-vote concept is part of the foundation of the free enterprise system as we know it in the United States. I hope very much that the stock exchange turns down the proposed change and recognizes its responsibility to maintain high standards." In response to arguments that stockholders should be allowed to decide such questions for themselves, Whitehead said, "That's an appealing argument. But I would ask: if the stockholders vote to approve the company not issuing an annual report or not having an audit committee, would the stock exchange permit that? Should the exchange leave all of these principles up to the stockholders, or does the exchange itself stand for something? And what about the minority shareholders? If two-thirds of the stockholders approve of giving up their one-share, one-vote power, what about the one-third that vote against it?" Whitehead predicted that if the proposed rule change is adopted, "Eventually all companies will be controlled by some small, inside group. Public stockholders will not have any role or significant voting rights."

The subcommittee's recommendations must now be considered by the NYSE's public policy committee and its board of directors, both of which may solicit additional public comment. They also must be approved by the Securities and Exchange Commission, whose chairman, John S.R. Shad, has been attempting to promote voluntary action by all markets to protect shareholders' rights. Final action is unlikely before the end of 1985.

The rule change would not apply to new companies seeking to be listed on the exchange, but it would prevent an exodus of currently listed companies, such as Dow Jones, and Hershey Foods, which will have to leave the NYSE if the exchange does not adopt the proposal. If the proposed change is enacted, many other companies listed on the NYSE are also likely to propose dual class capitalization plans to shareholders.

Reincorporation

Some corporations have sought to shift the state in which they are incorporated in order to gain the advantage of more protective state incorporation laws available elsewhere. For example, some companies incorporated in California have decided to reincorporate in Delaware because of differences in state law that could prove important in a tender offer or a contest for control. California prohibits board classification and the use of supermajority voting requirements, and it also mandates that shareholders be allowed the use of cumulative voting in the election of directors, a right that makes it easier for minority shareholders to gain representation on the board. In contrast, Delaware permits supermajority voting requirements and classified boards, and it makes cumulative voting optional. Also in Delaware, directors who serve on a classified board may be removed only for cause.

Companies that propose to reincorporate in Delaware often argue that Delaware's state law gives a company increased flexibility and offers a predictable legal environment. As Baker International, a California corporation, noted in its 1983 proxy statement:

> Delaware has encouraged incorporation in that state for many years and has adopted comprehensive and flexible laws which are periodically updated and revised to meet changing business needs. Many American corporations have initially chosen Delaware for their state of incorporation or subsequently changed their corporate domicile to Delaware. Because of the many corporations domiciled in Delaware and Delaware's longstanding policy of encouraging incorporation in that state, the Delaware judiciary has acquired considerable expertise in dealing with corporate issues, and a substantial number of decisions have been rendered construing Delaware law and establishing public policies with respect to Delaware corporations. It is anticipated that Delaware corporate law will continue to be interpreted and explained in a number of significant court decisions, thus assuring greater predictability with respect to the corporation's corporate legal affairs.

Critics of corporate efforts to reincorporate in Delaware contend that, because of the greater flexibility of Delaware state law, companies are able to curtail certain shareholder rights as well as act without shareholder approval on such matters as lending money to company officers. They point out that reincorporation proposals are often accompanied by provisions that make it more difficult to oust incumbent management, approve takeovers, or elect directors not supported by management. Furthermore, Delaware has been criticized over the years for laws and court decisions that appear designed to attract incorporations. William L. Cary, in an influential 1974 law journal article, lamented that Delaware had the lead in a "race for the bottom" among states with favorable tax, trust and corporation laws, including Delaware precedents that he said were aligned with management in proxy contests and takeovers. One of the mottos during the 1970s for proponents of federal chartering of corporations became "Up from Delaware!"

A number of companies that have reincorporated to take advantage of these differences have taken the opportunity to add anti-takeover provisions to their new charters. Burroughs's 1984 reincorporation in Delaware illustrates the spectrum of restrictions on shareholder rights that can be included. Among the provisions included in the Burroughs proposal were the following:

-- Members of the board are elected by class rather than annually; directors may be removed only for cause, and then only if the holders of 80 percent of the shares entitled to vote approve.

-- Shareholders lost the right to call special meetings; only the board may call a special meeting.

-- An 80 percent vote is required to approve tender offers unless they have been approved by the board or unless certain fair price requirements have been met.

-- Repeal or amendment of the board classification, fair price and other antitakeover provisions require the approval of at least 80 percent of the shares entitled to vote.

In its proxy statement, Burroughs acknowledged that its reincorporation in Delaware would serve as a deterrent to possible takeovers and would curtail certain shareholder rights, but it said "the board feels that the benefits of seeking to protect its ability to negotiate with the proponent of an unfriendly or unsolicited proposal to take over or restructure the company outweigh the disadvantages of discouraging such proposals."

A new twist in the corporate governance arena is that some companies are reincorporating in states other than Delaware in order to take advantage of the protective provisions in special takeover statutes. Among the states that have adopted takeover statutes that contain fair price or other protective provisions are Ohio, Pennsylvania, Maryland and Minnesota.[5] Recently, for example, Pulte Home moved its state of incorporation from Delaware to Michigan. One major difference between Michigan and Delaware is that Michigan's law, unlike Delaware's, contains a fair price requirement. The Michigan law specifies that a merger between a 10 percent stockholder and a company incorporated in Michigan must be approved by 80 percent of the outstanding and two-thirds of the disinterested shares, unless the offer meets stringent fair price criteria. While Pulte Home has exempted itself from this provision, as permitted under the statute, a majority of its board may modify or repeal the exemption. If this were to happen, the state's fair price provisions would apply.

Although most reincorporations occur before a takeover attempt is ever launched, some companies have reincorporated in the midst of an antitakeover fight. One of the more highly publicized reincorporations in recent years was Gulf Oil's proposal, adopted in the midst of the 1983 proxy fight with T. Boone Pickens, to shift its state of incorporation from Pennsylvania to Delaware. Gulf's reincorporation affected shareholder rights in several ways. First, Gulf shareholders could no longer use cumulative voting in the election of directors. Second, the right of Gulf shareholders representing large blocks of Gulf stock to call special meetings of shareholders to consider various proposals affecting the company was terminated. Under Pennsylvania law, shareholders representing at least 20 percent of Gulf's voting shares, as well as the company's president and board of directors, had been eligible to call special meetings. Under Delaware law, special meetings may be called only by a company's board of directors or persons who are authorized by the company's charter or bylaws. The charter of Gulf's Delaware holding company had no provision for the calling of special meetings by shareholders. Third, with Gulf's reincorporation in Delaware, only the board--and not shareholders--could initiate amendments to Gulf's charter. Previously, amendments could be proposed either by the board of directors or by shareholders holding at least 10 percent of the voting shares of the company.

In another highly publicized episode, Carter Hawley Hale reincorporated during its successful effort in 1984 to ward off a tender offer from The Limited. The shift in state of incorporation from California to Delaware allowed CHH to abolish cumulative voting. In its proxy statement, CHH said, "The principal reason for the reincorporation proposal is to prevent The Limited from gaining representation on the company's board of directors." The company also: (1) eliminated the right of holders of 10 percent or more of the voting securities to call special shareholder meetings; (2) restricted the right of major shareholders to obtain shareholder lists; and (3) limited the availability of appraisal rights, which provide an opportunity for shareholders to receive a higher price if they believe they have been treated unfairly in a merger or acquisition.

Other Antitakeover Charter Amendments

In addition to the antitakeover charter amendments described above, other measures to prevent takeovers voted on by shareholders include:

- Elimination of cumulative voting, if it is in use, in favor of electing all directors by majority vote. When cumulative voting is in effect, each shareholder has a number of votes equal to the number of shares owned multiplied by the number of directors to be elected. Shareholders can cast their votes for a single director or apportion their votes among the candidates. Thus, at a company with 10 seats, cumulative voting would make it possible for owners of 11 percent of the stock to elect one director. The owners of 51 percent of the shares could be assured of electing only five directors, as opposed to the usual situation where 51 percent is sufficient to elect the entire board. Using cumulative voting, a well-organized minority of stockholders may be able to elect an effective opposition to existing management.

- Adoption of a rule that would institute cumulative voting in the event that a shareholder or a group of holders obtain a majority or near-majority, such as 40 percent, of a company's voting stock. This diminishes the ability of a corporate raider to accumulate voting power sufficient to elect all directors, and may allow management and other interests to elect directors defending against the takeover.

- Amendment of the corporate charter to limit the voting rights of shareholders holding large blocks of stock. One company that has adopted this tactic is MCI. In 1983 the company adopted an amendment which specifies that a holder of more than 10 percent of the outstanding shares of the corporation is entitled to only 1/100 of one vote for each share in excess of 10 percent unless the holder commences a full tender offer. The provision is intended to ensure that a bidder could not gain control of MCI unless he bid for all of the company's voting stock.

- Changes to prohibit shareholders from calling a special meeting or from acting by written consent. The effect is to delay action by potential acquirers or other shareholders, and thereby either discourage takeovers or give the company more time to mount a defense. Companies usually contend that these prohibitions will restrain majority stockowners from acting unilaterally without consulting minority holders.

- Amendments to require a shareholder who exceeds a specified percentage of a company's securities to begin a tender offer for the remaining securities of the corporation. These provisions, sometimes called mandatory bid provisions, may require that the mandatory tender offer price be at least equal to the highest price paid by the shareholder in acquiring his initial percentage. The effect of a mandatory bid provision is to prevent an acquiror from buying a substantial percentage of a company's stock and then making a partial tender offer.

- Amendment of the corporate charter to direct the board of directors to consider non-monetary factors when deciding whether to approve a tender offer. Factors to be considered may include the financial condition and earnings prospects of the bidder, the competence or integrity of the bidder, and the social and economic effects on the target's employees. Among the companies that have adopted this type of charter amendment are Control Data and McDonald's.
- Creation and maintenance of employee stock ownership plans, stock option plans and other devices to give employees incentives to purchase and hold their employer's stock. Employees often resist takeovers out of loyalty and out of fear that new owners or managers may cut jobs. Corporations may also believe that they can influence their employees' decisions on tender offers, or the decision of a trustee for an employee benefit plan, more readily than they can influence decisions by other shareholders.

The Effects of Shark Repellents

As antitakeover amendments have been adopted with increasing frequency, debate about their effects has intensified. Many institutional investors now view shark repellents as a tool employed by management to forestall the possibility of takeover.

As such, these investors believe, they represent a move by management to restructure the takeover market in favor of management rather than shareholder interests.

While institutional shareholders increasingly believe that the amendments protect management, managements assert that the provisions are designed to protect the interests of shareholders. Managements' argument for the measures is that, in an increasingly hostile takeover environment, antitakeover amendments are necessary to strengthen the corporation's bargaining position. Without them, managements say, the firm may not be able to resist a takeover attempt that is against shareholders' interests.

To justify their claim, managers point to the growing concern over the consequences of hostile takeovers. In particular there is considerable sentiment among managers that their unwanted preoccupation with the possibility of hostile tender offers is distracting them from pursuing long-term business strategies that are in the best interests of the company's shareholders and other important constituencies.

Despite the debate that they have generated, there has been very little empirical evidence about the effects of antitakeover charter amendments. In the last two years, at least four studies of antitakeover amendments have appeared. All four restrict their examination to an analysis of the effects that adoption of antitakeover amendments has had on the stock prices of the companies adopting them. Measuring the immediate stock price reaction to antitakeover amendments is an indirect way of analyzing their effects on shareholders. The price reaction amounts to a poll of what the market thinks the future effects of the amendments will be on takeover battles.

Of these four studies, two found that antitakeover amendments had a negative effect on stock prices; one found a positive effect; and one found no change. While the four studies offer different conclusions about the direction of antitakeover amendments' stock price effects, they offer similar descriptions of the magnitude of these effects. Three of the four studies show average stock price effects ranging from 0 to 2 percent--in other words, small by any absolute measure.

The fourth suggests somewhat greater price effects for a portion of the sample examined. Published in November 1984 by the office of the chief economist of the Securities and Exchange Commission, the report ("Shark Repellents: The Role and Impact of Antitakeover Charter Amendments") examined changes in stock prices at companies that between 1980 and 1983 had adopted either fair price or supermajority charter amendments.[6]

The SEC sample includes 171 firms that had adopted fair price proposals between 1980 and 1983, 131 of which were listed on the New York or American Stock Exchange and 40 of which were traded over the counter. Eighty-seven of the 131 NYSE and AMEX firms also adopted supermajority proposals, as did most of the OTC firms. Stock prices of these companies were charted for a period from 40 trading days before the proxy mailing containing the relevant charter changes to two days after the mailing. The prices of the 131 NYSE and AMEX companies were found to have declined by nearly 2 percent. The 87 companies that had adopted both antitakeover measures experienced a 3 percent decline, on average, while the stock prices of the 40 OTC companies fell by an average of 5 percent. The aggregate capital loss to shareholders of these stock declines was about $1.35 billion.

The study points out that not only do shareholders of these companies suffer the direct loss of declining stock prices, but they also often forgo potential large premiums from takeover-related stock price increases that are prevented by the charter amendments. It also states that antitakeover measures cause a decrease in managerial accountability to shareholders, and that management may fail to maximize the value of a firm's equity if takeovers are not a threat.

The current controversy over the amendments would suggest that such a poll would be largely inconclusive, because market participants are divided and uncertain about the actual effects of the amendments.

Our own analysis, published in early 1985, presents what we believe is the first empirical evidence of the effects that shark repellents have on contests for control.[7] We sought to determine the answers to four related questions:

(1) Do antitakeover amendments discourage takeover attempts?

(2) Are takeover premiums higher or lower in the presence of antitakeover amendments?

(3) Do the amendments signal that a firm is more likely to resist a takeover attempt?

(4) Is resistance to takeovers more successful in the presence of the amendments?

The methodology used was comparative, analyzing differences between samples of firms with and without antitakeover amendments. Our analysis yielded the following results:

- The presence of antitakeover provisions in a corporation's charter results in fewer takeover attempts. Of the firms examined, 38 percent that did not have the amendments were the subject of acquisition bids, while only 28 percent of the firms with antitakeover provisions in their charters were takeover targets. This is a statistically significant difference.

- The presence of antitakeover provisions in a corporation's charter does not mean that shareholders will receive a higher premium if the company is subject to a takeover. Takeover premiums over market price were on average slightly (8 percent) higher for firms in the antitakeover sample than for firms in the control sample. However, underlying these average figures were quite high variations in premiums across the individual firms examined. The size of these variations means that the difference in average premiums cannot be considered statistically significant.

By another measure, book value, takeover premiums were considerably lower for firms with antitakeover provisions. On average, shareholders in firms with antitakeover amendments realized a 72 percent premium over book value based on the final acquisition bid, while shareholders in firms without antitakeover amendments realized a 105 percent premium. In other words, shareholders in firms without the amendments realized a 33 percent greater premium over the basic value of their corporations' assets from acquisition attempts. This difference is statistically significant.

- Firms with shark repellents resist takeover more often than firms without shark repellents. Sixty-eight percent of the firms in the antitakeover sample resisted acquisition, while only 36 percent of those in the control sample showed resistance. The difference between these frequencies is statistically significant.

- Management resistance to takeover attempts is far more successful among targets with antitakeover amendments. Managements of firms with the amendments are far more likely to achieve a result they find acceptable, whether it is renegotiating the terms of the takeover to their satisfaction, or ultimately retaining autonomy. This suggests that antitakeover amendments do in fact confer considerable bargaining power on the firms that have adopted the amendments.

On the surface, these results suggest that shark repellents are contrary to the interests of shareholders. This impression is strengthened by an analysis of financial performance of takeover targets with and without shark repellents. An examination of the ratio of market price to book value immediately before a takeover bid for firms with and without antitakeover provisions in their charters reveals a substantial difference between the average price:book value ratio among takeover targets with and without antitakeover amendments. Targets with the amendments had, on average, a 41 percent lower price:book ratio than targets without the amendments. This is a statistically significant difference. Targets with the amendments exhibit an average price:book ratio of almost exactly 1, suggesting that management is perceived to be adding negligible value to these corporations. By contrast, targets without antitakeover amendments show an average price:book ratio of nearly 1.5, suggesting that management adds a significant premium to the value of these corporations' assets.

Underlying this difference in average price:book ratios is an equally noticeable difference across the two samples in the proportion of firms having price:book ratios below 1. Fifty-two percent of targets with antitakeover amendments showed price:book ratios below 1, compared with only 25 percent of firms in the control sample. This difference, too, is statistically significant.

Price:book ratios are clearly not the only appropriate measure of a firm's financial performance; they are, further, imperfect, because of the difficulties inherent in assessing the absolute worth of corporate assets. However, because they relate corporations' absolute worth to the relative worth attached to them by the financial community, they are illuminating.

The differences in price:book ratios for the two samples examined here suggest that there is a fundamental difference in the performance of takeover targets with antitakeover amendments. This performance difference implies that the market perceives managements of firms with the amendments as doing a significantly worse job of managing the corporations' assets. In more than half the cases examined, the market perception was that the current management was actually of negative net worth to the corporation.

This evidence suggests a motivation both for the differences in takeover behavior described in earlier sections, and for the adoption of antitakeover amendments themselves. Managements of targets with antitakeover amendments may correctly perceive both that their firms are likely to become takeover targets, given the low current market price of the assets, and that in the event of a control transfer, they will be replaced. Thus, they adopt antitakeover amendments to protect their positions, and utilize these amendments to resist takeover attempts when they do occur.

Although it is inferential, our evidence nonetheless strongly suggests that shareholders who oppose antitakeover charter amendments are correct in arguing that shark repellents are contrary to shareholders' interests. The evidence also casts doubt on the assertions that shareholders should approve shark repellents because they will result in a better deal for shareholders if a company becomes a target of a takeover attempt.

The evidence does not necessarily mean, however, that antitakeover amendments and management resistance to takeovers is harmful to the economy as a whole. The evidence that shareholders are harmed by the amendments is a distributional result, one in which management appears to be acting in its own self-interest at the expense of shareholders' interests. Thus, these results do not address the issue of whether the amendments and management resistance are harmful in terms of economic efficiency, or whether they adversely affect employees, consumers, host communities or other groups.

Notes

1. See Antitakeover Charter Amendments: A Directory of Major American Corporations. Investor Responsibility Research Center, 1985.

2. See The Economics of Partial and Two-Tier Tender Offers. Report of the Office of the Chief Economist, Securities and Exchange Commission, June 21, 1984.

3. See Advisory Committee on Tender Offers: Report of Recommendations. Securities and Exchange Commission, July 8, 1983.

4. See Dual Class Capitalization: The Initial Report of the Subcommittee on Shareholder Participation and Qualitative Listing Standards. New York Stock Exchange, Jan. 3, 1985.

5. See Federal-State Conflicts Involving Tender Offer Regulation. Investor Responsibility Research Center, 1985.

6. See Shark Repellents: The Role and Impact of Antitakeover Charter Amendments. Office of the Chief Economist, Securities and Exchange Commission, Sept. 7, 1984.

7. See The Impact of Antitakeover Charter Amendments on Contests for Corporate Control. Investor Responsibility Research Center, 1985.

II. GREENMAIL AND POISON PILLS

Antitakeover charter amendments usually are adopted in anticipation of a hostile takeover attempt. Their principal effect is either to deter a hostile takeover attempt by putting potential acquirors on notice that a target company's management is likely to resist, or to encourage a potential bidder to negotiate directly with the management of the target by making it more difficult, or more expensive, to gain control of the target without the consent of its management.

Charter amendments are not the only means by which the managements of target companies can fight nostile takeover attempts. They may, for example, repurchase on the open market or make a tender offer for their own shares to keep them from falling into the hands of a hostile bidder. They may issue additional shares of common stock, to dilute the holdings of a potential acquiror. They may initiate an acquisition attempt of their own, in the process expending cash reserves or adding debt, both of which are likely to make them less attractive to a hostile bidder. Or they may sell their most valued assets (their "crown jewels") to a third party, knowing that the remaining assets are likely to be of little interest to a potential acquiror.

While these tactics are controversial, and perhaps not always in the best interests of shareholders, they nonetheless usually involve transactions in which the target company receives something of value. In contrast, two other practices--greenmail and the issuance of poison pills--can have extreme adverse effects on shareholders, and unlike the procedure for adoption of antitakeover charter amendments, shareholders are given no opportunity to vote on a company's decision to pay greenmail or to issue poison pills.

In the case of greenmail, the management of a target company typically pays a substantial above-market premium to repurchase shares from a hostile bidder in exchange for agreement by the bidder not to attempt to gain control of the company for some specified period of time. Poison pills are designed to trigger events that can have devastating financial effects on either a target company or, in some cases, a bidding company if it gains control of the target. Both practices have been widely condemned, and efforts are now underway to curb both greenmail and poison pills.

Recent Greenmail Episodes

Generally, greenmail transactions follow the same pattern: A shareholder accumulates stock, threatens a tender offer or proxy fight for control of the company in question and then makes a deal to sell the stock back to the company, usually at an above-market price, and usually in exchange for an agreement by the greenmailer not to attempt to gain control of the target company for some specified period.

Table 1 lists some of the major buybacks that occurred in 1984. According to The Wall Street Journal, the nine largest greenmail stock repurchases from large shareholders in 1984 resulted in a total expenditure of more than $2.5 billion.

Table 1

Major Stock Buyback Deals of 1984

Premium over mkt. value (%)	Company	Seller	% stake	Price ($ millions)	Month of deal
12	Texaco	Bass Brothers	9.9	1,280.0	Mar.
17	Phillips Petroleum	Mesa Partners	5.8	471.7	Dec.
19	Walt Disney	Saul Steinberg	11.1	325.0	June
42	Warner Communications	Rupert Murdoch	6.7	180.0	Mar.
30	St. Regis	James Goldsmith	8.6	100.0	June
28	Pioneer	undisclosed	less than 5	83.0	Sept.
28	Quaker State Oil	Saul Steinberg	8.9	47.0	Apr.

Sources: Compiled from The Wall Street Journal, Kidder Peabody and other sources.

The deal between Saul Steinberg and Walt Disney Productions in June 1984 is a good example of how greenmail works. The first step in a greenmail deal is the acquisition of a block of stock that is large enough to provide leverage over the company, a move sometimes referred to as establishing a "foothold." Steinberg began acquiring Disney stock on the open market in early 1984. On March 29 he disclosed in a required filing with the Securities and Exchange Commission that he owned 6.3 percent of Disney's shares. Disney's stock price rose significantly as speculation increased that the company would be taken over.

By May 1, Steinberg had acquired 12.1 percent of Disney's stock, a large enough foothold to prompt Disney to begin moving to avoid a possible hostile takeover. Disney's defensive moves included two major issuances of previously authorized shares worth more than $500 million to purchase a Florida real estate concern and Gibson Greeting Card Corp. These share issuances served to dilute Steinberg's holdings, but not significantly enough to deter him. Steinberg made a tender offer on June 8 for 49 percent of Disney's shares, valued at $970 million. Steinberg's offer prompted negotiations between the two parties, and on June 11 Disney agreed to buy back Steinberg's 11.1 percent holding for $325 million, nearly $60 million above the market price. Included in the selling price was $28 million to compensate Steinberg for expenses incurred in the deal. Steinberg agreed not to purchase any of Disney's stock for the next 10 years.

Often greenmail transactions occur before a tender offer is made or a proxy contest initiated. For example, in a transaction between Texaco and the Bass Brothers the mere threat posed by the brothers' 9.9 percent holding prompted Texaco to buy back its stock. The Bass Brothers had never threatened publicly to launch a tender offer or a proxy contest before the deal. In one of the largest greenmail deals ever, Texaco repurchased nearly $1.3 billion of its stock on March 17, 1984, at an above-market premium of 12 percent.

The Effects of Greenmail

One of the main reasons that greenmail is widely denounced is that the stock buyback often has far-reaching effects on the company involved. Disney, for example, doubled its long-term debt with loans used for its defensive acquisitions and loans needed to raise the funds used to buy out Steinberg. Disney's increased borrowing raised its debt-equity ratio to about 60 percent. The new debt, combined with a one-seventh increase in its outstanding common stock and the withdrawal of Steinberg's takeover bid, caused Disney's stock price to drop nearly 16 points in less than a week, representing a decline in market value of more than $600 million, or one-fourth, during that period.

A recent SEC study has found that a drop in stock price after greenmail occurs is not unique to Disney.[1] The study uses data from 1979 to 1983 on the stock prices of companies that repurchased stock at an above-market price to avoid a takeover. The aggregate above-market premiums paid in greenmail cases during this period was more than $1 billion. According to the study, the evidence gathered "suggests that non-participating shareholders suffer substantial and statistically significant share price declines upon the announcement of targeted repurchases at premiums above market value." It continues that these price declines more than offset any price increases that occur when the shareholder is acquiring his foothold. The average price decline in the period from 20 days before the foothold acquisition to five days after the repurchase is 3.7 percent, an amount roughly equal to the average premium paid to the seller of the block of stock.

The Controversy Behind Greenmail

The recent rise in greenmail activity has spurred lively public debate on several issues, including who is to blame for greenmail activity, whether action should be taken to prevent greenmail and, if so, what that action should be.

Much of the publicity surrounding greenmail has focused on the abuse by the investor or "raider" who disrupts a company and persists until he is paid a large sum of money. Critics of greenmailers believe that the takeover threats are hollow and therefore the raider's behavior is simply a means of disrupting a company's normal business operations until a deal is made. The threat of greenmail, this argument goes, forces management to shift attention from the development of a long-term business strategy to defending against a raid. Martin Lipton, a leading takeover lawyer, notes, "as matters now stand, the only practical solution for a corporation seeking to maximize long-term values for its shareholders is to give in and purchase the accumulated shares."

Other critics of greenmail blame management for paying premiums to greenmailers. These critics argue that the officers of a company, fearing a takeover, use greenmail to thwart a change in control of the company in order to protect their jobs. In this view, greenmail payments are a short-term solution to the long-term problem of an undervalued stock price. Many shareholders have argued that if buybacks at a premium were really in the best interests of the company, management should make the same buyback offer available to all shareholders, not just the greenmailer.

Regardless of whether greenmail critics blame management or corporate raiders for greenmail activity, there is a great deal of support among them for legislation to curb the practice. In 1984 antigreenmail legislation was introduced in Congress as part of broader tender offer reform legislation but failed to pass when time expired on the session. The legislation would have prohibited a company subject to a tender offer from repurchasing its own securities at an above-market price from a shareholder holding more than 3 percent of the company's stock who had held that stock for less than two years. Buybacks would have been permitted if a majority of shares not affiliated with the greenmailer approved, or if the same offer were made to all shareholders.[2] The antigreenmail proposals had been recommended initially by the Securities and Exchange Commission, in response to the recommendation it received from the private sector commission it had appointed to review tender offer abuses.

Proponents of the legislation (including the SEC) argued that the provision would restrain corporate raiders from extracting payments from companies while increasing management accountability to shareholders. Critics of the antigreenmail provisions of the legislation generally were few. Since the legislation died with the last Congress, and the Reagan administration decided in early 1985 to oppose new federal legislation regarding hostile tender offers, the prospects for enactment of legislation this year are uncertain.

Antigreenmail Charter Amendments

Congress's failure to enact the proposed antigreenmail legislation in 1984 has prompted some companies to take action to protect themselves from the threat of greenmail by proposing to amend their charters to prohibit certain stock buybacks at above-market prices without shareholder approval. The first such charter amendment, proposed by the management of International Minerals & Chemical Corp., was approved by shareholders at IMC's annual meeting in October 1984. Since then, more than 30 corporations have asked shareholders to approve charter amendments that are intended to discourage the payment of greenmail. Among them are Chesebrough-Pond's, Diamond Shamrock, Dresser Industries, Martin Marietta, Mobil and NCR.

The proposals vary considerably. Some, such as IMC's, are unadorned antigreenmail devices. The IMC charter amendment states that the company is prohibited from purchasing any of its stock at an above-market price from a stockholder who owns more than 3 percent of the outstanding common stock and who has purchased any of that stock within the previous two years. Repurchases would be permitted only with the approval of a majority of the company's outstanding shares, excluding the shares owned by the selling stockholder, or if the company offered to pay the same price to all stockholders.

The antigreenmail management proposals drafted by other companies are substantially similar but differ slightly regarding the amount of stock that an investor must acquire to activate the antigreenmail provisions, the length of time the interested shareholder must own the stock, and the vote required to approve the transaction. As a rule of thumb, the broader the definition of the universe of transactions that must be approved by shareholders, the greater the shift of decisionmaking power from management to shareholders and the greater the number of stock repurchases that are likely to be prevented.

Some companies have combined antigreenmail charter amendments with fair price, board classification or other shark repellents and submitted them together for a single vote. For example, at its 1985 annual meeting, Bausch & Lomb coupled an antigreenmail charter amendment with antitakeover provisions requiring supermajority approval for mergers and supermajority approval to amend the charter. Companies taking this approach apparently hope to make the shark repellents included in the proposals more palatable to shareholders by coupling them with antigreenmail provisions.

As the number of antigreenmail proposals increases, the incidence of greenmail may decrease. One factor will surely be the increase in the number of companies amending their charters to prevent greenmail. In addition, because greenmail has been denounced by nearly every person who has commented on it, would-be greenmailers may be dissuaded from attempting to greenmail a company because of adverse publicity.

If the use of greenmail declines, however, greenmailers may turn more often to quasi-greenmail tactics that have the same effect on shareholders but that are outside of antigreenmail charter amendments. For example, in a deal with Chesebrough-Pond's in April 1984, Carl Icahn sold his 5 percent share of the company's stock at market price to the company, but as part of the deal Chesebrough also agreed to purchase Polymer Corp., a division of the Icahn-owned company ACF Industries. The price paid for Polymer, $95 million, was considered to be above fair market value.

It is also possible for corporate raiders to circumvent the antigreenmail barriers in a charter amendment by maintaining holdings in a target company that are slightly beneath the threshold level that triggers the amendments or by holding their shares long enough to comply with the holding period requirements in an antigreenmail proposal. However, a management that urges shareholders to approve an antigreenmail proposal and then later pays greenmail, even if its actions comply technically with the provisions of its charter, runs the risk of forfeiting the trust and goodwill of its shareholders and the investing public.

The Use of Poison Pills

Last year marked the beginning of a new trend among companies attempting to strengthen defenses against hostile takeover attempts when several major companies created poison pills. First adopted by Lenox in 1983 to fight a hostile takeover attempt by Brown-Forman Distillers, poison pills have been adopted by more than a dozen companies, including Household International. Crown Zellerbach, Owens-Illinois, Bell & Howell, Colgate-Palmolive and Phillips Petroleum. The poison pill refers to rights that are issued to holders of a company's common stock that entitle them to purchase a newly issued class of preferred stock, stock warrant or other type of security. The rights can be exercised only when a triggering event occurs, usually either a tender offer for the firm's shares or the acquisition by an outside party of a large block of the company's stock.

Once the triggering event occurs, the new securities can be exchanged either for shares of common stock in the acquiring company at a substantial discount or for cash on very favorable terms (such as the highest price per share paid for the target's stock that year). The special redemption and conversion privileges of the new issuance of stock make the target company prohibitively expensive to acquire, a "poison pill" that an acquirer would be forced to swallow in order to gain control of the company.

Although individual features may vary, poison pills are similar in design. The Household International case illustrates how they are intended to work. Household's poison pill was designed for the company by Martin Lipton, one of the country's leading attorneys specializing in takeover defenses. Lipton is widely credited with having invented the device when Lenox turned to him for assistance in 1983.

Like others, the Household International poison pill is extremely complex. It was approved by the company's board at a meeting on Aug. 14, 1984, and distributed to shareholders as part of what the company described as a "preferred share purchase rights plan." The plan provides that shareholders would receive one right for each share of common stock. Each right entitles the holder to buy 1/100 share of a new series of preferred stock at a price of $100 for each 1/100 share, or $10,000 a share for each preferred share.

Household's triggering event is defined as any one of a series of actions in which a potential acquiror obtains ownership or control of either 20 percent or 30 percent of Household's common stock. Once a triggering event has occurred, the rights may be converted into securities of the bidding firm on terms that are very favorable to Household's shareholders--in effect permitting them to acquire stock in the bidding company at one-half its market value.

The likely result would be a substantial dilution of the acquiring company's capital. The rights plan would not necessarily deter all hostile offers, but it would be particularly effective against two-tier offers, and it would encourage potential bidders to negotiate directly with Household's board of directors.

Household's poison pill relies on the company's blank check authority to issue preferred stock because the warrants issued convert into a new class of preferred after the triggering event occurs. Other companies, including Phillips Petroleum, have structured their poison pills so as not to use preferred stock.

As part of its takeover defense against Carl C. Icahn in February 1985, Phillips disclosed in its proxy statement that its board of directors had approved the issuance of special note purchase rights to all of its stockholders that it said would "deter two-tier and bust-up takeovers at prices that do not reflect a fair value for the company." One right was issued for each share outstanding as of Feb. 18, 1985. If any person or group were to acquire 30 percent of the company's outstanding common stock, each right would enable the bearer to swap common stock of the company for one-year notes valued at $62 bearing 15 percent interest.

Rights of this sort have the same effect as the Household poison pill because they serve to make the company either an unattractive target or prohibitively expensive to acquire. Phillips's poison pill was intended to ensure that any offer to acquire the company would be valued at a minimum of $62. But since the rights simply guarantee holders $62 in securities after the triggering event and are not convertible into preferred stock, Phillips was able to adopt the plan without having authorized blank check preferred.

The Legality and Effectiveness of Poison Pills

Perhaps the single biggest stumbling block to widespread use of poison pills has been uncertainty about their legality. On Jan. 29, 1985, a Delaware chancery court upheld the legality of Household International's poison pill. The decision could provide considerable encouragement to other corporations chartered in Delaware to use poison pills, unless it is overturned on appeal.

Adoption of the rights plan was opposed by two Household directors, including John A. Moran, chairman of an investment firm that is Household International's largest stockholder. Moran at one time had expressed an interest in acquiring Household through a leveraged buyout, but even before that the company's top management had become concerned about hostile bids from other sources. After Household's board decided to adopt the rights plan, Moran filed suit in the Delaware chancery court challenging the legality of the plan.

Moran's major argument was that the plan has far-reaching effects on the rights of shareholders and should have been submitted to them for approval. Several well-known investment bankers and economists testified in support of this position. In response, Household emphasized that the board had made a careful and deliberate assessment of the company's vulnerability to hostile takeovers and had concluded that the best interests of shareholders would be served by adoption of the rights plan and other antitakeover measures that the board had approved at its Aug. 14 meeting.

Both sides argued about the applicability of the business judgment rule, a judicial standard of review that generally provides that a company's directors will not be held liable for mistakes in judgment, absent fraud or bad faith, provided they have acted in an informed manner. Household emphasized that its conduct met the standards of the business judgment rule and that, therefore, the wisdom of its decision to adopt the poison pill should not be questioned by the court. Moran attempted to persuade the court that the business judgment rule should not apply, or that, if it did, the burden of proof should be shifted to Household to justify its actions.

The court's decision[3] was a victory for Household. The court refused to rule that the poison pill so fundamentally affected shareholders' rights that the company was required to submit it for their approval. It rejected Moran's position on the business judgment rule. And it held that the adoption of the rights plan itself was "an appropriate exercise of managerial judgment under the business judgment rule."

The court observed that Household's board "has an informed basis for believing that Household was vulnerable to a two-tier takeover and that the adoption of a deferral plan was required." The court added that it was satisfied that the plan had been "properly adopted under Delaware law, is not intended primarily for entrenchment of management and serves a rational corporate purpose." It agreed that some features of the plan could affect shareholder voting rights or rights of alienation, but it characterized those features "as necessary to protect the corporation and all its constituencies from the coercive nature of certain partial tender offers."

Both the Securities and Exchange Commission and the Investment Company Institute, a major trade group representing the mutual fund industry, have filed amicus briefs asking the Supreme Court to reverse the lower court's decision. Although the case involves state corporation law and not federal securities laws, the SEC said it was taking the unusual step of filing an amicus brief because it believes the issues presented in the case could have lasting effects on the rights of shareholders to consider changes in corporate control. "Based on our experience in this area," the SEC said in its amicus brief, "it is our view that the Household plan would deprive shareholders of an opportunity to consider virtually all hostile tender offers, would also have a significant deterrent effect on proxy contests against management, would thereby entrench management against efforts to oust it, and thus is not in the shareholders' interests."[4] The Investment Company Institute's principal argument is that Household's board lacks authority to adopt the rights plan without submitting it to shareholders for their approval.[5]

Whether large numbers of companies decide to adopt poison pill defenses may depend not only on the outcome of the Household case, but also on perceptions about the effectiveness of these defenses. Until recently, poison pills were widely regarded as among the most potent antitakeover defenses that a corporation could invoke. But several recent events suggest that they can backfire in some circumstances. The efforts of Phillips Petroleum in early 1985, for example, to persuade stockholders to approve a recapitalization plan were undermined when it adopted a poison pill. After shareholders refused to approve the initial recapitalization plan, Phillips offered a more generous plan. More recently Cooper Laboratories, a major stockholder in Rorer, solicited proxies from Rorer stockholders in support of a shareholder resolution requesting Rorer's board to rescind a recently adopted poison pill. Cooper won the support of a majority of the shares voted on the resolution, which, however, is not binding on Rorer. Rorer has since announced that it will not rescind its poison pill. It remains to be seen whether Cooper Labs or other stockholders will take further measures aimed at changing Rorer's policy or ousting the board.

Crown Zellerbach's poison pill, which is similar to Household's, apparently was a factor in Sir James Goldsmith's recent decision to terminate a hostile tender offer for Crown Zellerbach. But Goldsmith has continued to accumulate shares of Crown Zellerbach, and he may yet win control of the company, or at least position himself to exert significant influence over its actions, even though the size of his holdings have activated the "flip-over" provisions of Crown Zellerbach's poison pill. The pill would take effect if Goldsmith attempts to merge Crown Zellerbach into another company, but it may have no direct effect otherwise.

Notes

1. See The Impact of Targeted Share Repurchases (Greenmail) on Stock Prices. Office of the Chief Economist, Securities and Exchange Commission, Sept. 11, 1984.

2. See "Tender Offer Reform Act of 1984," HR 5693, and the Report (H Rep. 98-1025) of the House Energy and Commerce Committee, Sept. 7, 1984.

3. See Moran v. Household International, Chancery Court of Delaware, Jan. 29, 1985.

4. Brief Amicus Curiae of the Securities and Exchange Commission, March 19, 1985.

5. Brief Amicus Curiae of the Investment Company Institute, March 18, 1985.

III. THE ROLE OF INSTITUTIONAL INVESTORS IN THE CORPORATE GOVERNANCE PROCESS

Institutional investors traditionally have taken a fairly passive role on corporate governance matters. During the 1940s, the trust division of the American Bankers Association did urge bank trust departments to establish procedures to vote stock held in trust accounts. But even the ABA guidelines suggested that banks should normally vote the stock in favor of management recommendations on both routine and nonroutine items, the theory being that a vote contrary to management's recommendation on a particular item involved an implicit vote of no confidence in management's general conduct of the business, which should trigger the sale of the stock involved.

This line of thinking became widely accepted within financial circles; eventually it led to the development of what became known as the Wall Street Rule. In practice, the Wall Street Rule meant that institutions either supported management's position on proxy questions or sold the stock of the company involved. The rule gained acceptance at a time when institutional stock holdings were relatively small, controversial items presented for a vote relatively few, and standards of institutional accountability in American society somewhat less demanding.

The decade of the 1970s witnessed significant changes. Fueled by the rapid growth of pension fund assets under institutional management, stock holdings of institutional investors increased dramatically. Thus began the demise of the Wall Street Rule, as the size of institutional holdings began to affect both the liquidity of those holdings and the attitudes of institutions about their fiduciary responsibilities. The enactment of the Employee Retirement Income Security Act (ERISA) in 1974 established federal fiduciary standards that have heightened sensitivity about the role that pension funds play in the corporate governance process.

The recent wave of highly publicized mergers and takeovers has drawn attention to efforts by incumbent managements to create the kinds of barriers to hostile tender offers that are described in the first two parts of this report. Some major financial institutions acting as fiduciaries have taken strong exception to these proposals, which many regard as unjustified usurpations of shareholder rights by executives who are attempting to insulate themselves from the competition of the marketplace.

At the same time, however, financial institutions managing pension funds and other fiduciary accounts have business relationships with corporations that can create potential conflicts of interest. Pension fund managers, for example, may be asked to vote for antitakeover charter amendments by companies whose pension funds they manage. Banks and insurance companies may have lending or underwriting relationships with corporations that could be jeopardized if they opposed antitakeover charter amendments or supported hostile efforts to change corporate control. Even if pension fund managers do not have business relationships with a company, they may be reluctant to take actions that will offend a potential future client. These potential conflicts of interest put pension fund managers in the position of possibly violating their fiduciary responsibilities under ERISA if they act to advance their own business interests rather than to protect the interests of pension fund participants.

The Wall Street Rule

Institutional investors traditionally have avoided conspicuous involvement in corporate decision-making. The norm for banks, insurance companies and other investment managers has been to follow the Wall Street Rule and either to support management's position on matters put to shareholders for a vote or to sell their holdings. As the Securities and Exchange Commission noted in a multivolume study on institutional investors, published in 1971:

> Such data as is available tends to show that institutions tend to vote with management on questions put to a shareholder vote and that if they lose confidence in management they tend to sell their holdings in a company rather than to attempt to control or influence management decisions. This conclusion appears attributable to two factors. First, institutions are inclined to believe that their responsibility is to make investment decisions rather than to attempt to influence management decisions. Second, while there are no statutory restrictions upon the right of institutions to attempt to influence management decisions, institutions tend to believe that an effort to do so would be inappropriate and would subject them to criticism. Over half of all institutional respondents to the study's questionnaire did not respond to specific policy questions, asking them to submit their own views about the appropriate role of institutions as shareholders.
>
> With respect to voting, the practices of institutions vary. Thus institutions, particularly banks, which act as trustees, believe that they are under a fiduciary

> duty to cast an informed vote and, consequently, formal procedures, more or less elaborate, are followed in analyzing proxy statements and arriving at a decision as to which way they will vote. In the case of other institutions, these decisions tend to be made on a more informal basis. Banks also tend to vote negatively and to abstain from voting more frequently than do other institutions. Abstention from voting would ordinarily indicate lack of agreement with the particular proposal presented without demonstrating a lack of confidence in management which a negative vote might indicate.
>
> Institutions are more likely to take a definite position on those questions which have a clear impact on their economic position and rights as shareholders. These include proposals to abolish preemptive rights, authorization of mergers, and authorization of corporate acquisitions, particularly where such acquisition involves issuance of additional securities. In general, it can be concluded that even where institutions have the potential power to influence management decisions they tend to be reluctant to exercise this power, particularly in an open and public way. While there are, no doubt, instances where institutions influence corporate decisions informally through personal consultations with management, reliable statistical evidence of the extent to which this occurs is not available.[1]

Almost 10 years later, in another major report entitled Staff Report on Corporate Accountability (1981), the SEC noted that there had been a clear trend away from reliance on the Wall Street Rule during the 1970s:

> While the Wall Street Rule may have been excusable when institutional equity holdings were small and electoral issues were complicated, by the early 1970s, its viability was being challenged by many factors. First, investment managers with sizable and expanding equity holdings discovered that they could not rapidly dispose of such holdings without a potentially adverse effect on the selling price. Second, emerging trends in fiduciary responsibility emphasized the importance of care in the exercise of voting authority. Knowledgeable investment intermediaries sometimes found that if a company was basically a good investment some alternative to divestment might be in order. Third, the rising tide of shareholder proposals included in issuer proxy statements often addressed ethical, social or general corporate governance issues that could affect the economic performance of the corporation. Shareholder activists lobbied institutions to support these proposals over the objections of management.[2]

A 1977 study prepared by economic consultant Julius W. Allen for the Senate Government Affairs Subcommittee on Reports, Accounting and Management also found that there had been a perceptible movement away from the Wall Street Rule during the 1970s.[3]

Despite the trend away from the Wall Street Rule, the practice still survives. The SEC gave a number of reasons in the 1981 staff report why institutions continue to follow the Wall Street Rule. It suggested that some institutions fear that critics might cite more active participation "as proof that institutions exert undue influence on U.S. corporations."[4] It also noted that banks and other institutions are not under significant legal pressures to change their voting policies and practices, because they have wide discretion in their role as trustees and because of the difficulty in proving that a trustee's action in voting securities had resulted in harm to beneficial owners. Third, the SEC reported, "there is a widely held attitude within institutions that establishing more elaborate voting procedures could be quite costly without any real prospect of commensurate improvement in the economic performance of portfolio companies."[5]

"Finally," the SEC report stated, "it has been argued that if reforms in institutional proxy voting procedures produce consistently diminished support for management's positions, other commercial relationships between the institution and the particular corporation might be jeopardized, and the institution might become less successful in attracting other companies' pension funds."[6]

The reasons cited by the SEC for the survival of the Wall Street Rule remain valid to a degree--particularly concern about offending clients and would-be clients. But even so, other developments have had a countervailing influence, contributing to the continued erosion of support for the passive norm.

One important development was the enactment in 1974 of the Employee Retirement Income Security Act. ERISA establishes federal statutory duties of loyalty and prudence for sponsors, trustees and managers of private pension funds. The growth in the size of pension funds also has had important effects. By various estimates, pension fund assets (including public funds assets) now total approximately $1 trillion, and pension funds have been estimated to own more than 30 percent of the common stock of publicly traded corporations. Many major corporations are now predominantly owned by pension funds and other institutional investors, and this has put pension fund sponsors and managers in a position to exert considerable influence as decisionmakers in the corporate governance process. Moreover, the size of a pension fund's holdings in a corporation can create liquidity problems and transaction costs that make it costly for investment managers to "vote with their feet." Finally, the types of corporate governance issues that corporations are asking shareholders to consider today are anything but routine: Many have far-reaching consequences for the rights of shareholders and the value of their investments.

Robert A.G. Monks, former administrator of the Labor Department's Office of Pension and Welfare Benefit Programs, took note of these circumstances on a number of occasions. In a May 17, 1984, speech, for example, he said, "When institutional investors don't vote, or vote without paying close attention to the implications of their vote for the ultimate value of their holdings, they are hurting not only themselves but beneficiaries of the funds they hold in trust." And, he added:

> It is the duty of the fiduciary of a pension plan under ERISA to scrutinize those actions of management which are put to a shareholder vote and to vote for the course of action which is best for the company, as that will be reflected, sooner or later, in an increase in the value of the company's shares, all other things being equal. Sitting on the sidelines, or blindly voting for management, would not, in my opinion, discharge the ERISA fiduciary's duty as shareholder. Casting a ballot, one way or another, with respect to an antitakeover measure, with an eye toward one's banking relationships rather than to the intrinsic merits of the measure, clearly violates ERISA.

Current Voting Policies of Investment Managers

Our firm has conducted three extensive surveys of how investment managers are responding to antitakeover charter amendments and other corporate governance issues. The first was conducted during the summer of 1981 and published in December 1981,[7] the second was conducted during the summer of 1983 and published in October 1983,[8] and the third, conducted in the summer of 1984, was published in September 1984.[9] In each survey we asked investment managers to describe their voting policies on anti-takeover charter amendments and on other corporate governance issues. In addition, in 1983 and 1984 we asked them to indicate how they voted on a representative sampling of the proposals that came to votes in each year. The respondents to these surveys have included many of the major bank trust departments, insurance companies and investment firms that are responsible for managing large amounts of pension fund assets subject to ERISA.

Very few of the investment managers responding to our surveys indicate that they treat antitakeover charter amendments as routine items or that they vote automatically in favor of management. Most firms have established policies and procedures to examine antitakeover charter amendments and other corporate governance issues. Bank trust departments appear to have more formal policies and procedures than insurance companies and investment firms.

Our 1981 survey, for example, generated responses from 31 banks, including the trust departments of 12 of the 20 largest commercial banks in the country. With few exceptions, banks responding to the 1981 survey said that they had established procedures to distinguish between routine and nonroutine issues, and 26 of the 31 banks said that they had established proxy committees to review and recommend voting positions on nonroutine issues. The 1981 survey also included 16 major insurance companies and investment firms, among them seven of the 10 largest life insurance companies in the country. Among this group of managers, written policies, formal procedures and proxy committees were less frequent, and individual analysts or portfolio managers were more likely to be given responsibility for making voting decisions.

The results of our more recent surveys indicate that major investment managers are continuing to examine antitakeover charter amendments carefully. Most of the investment managers responding to our 1984 survey, for example, said that they either oppose the most common types of antitakeover proposals or they examine them individually on their merits before making decisions. (See Table II.)

Table II

Voting Policies of Investment Managers on Antitakeover Proposals

	For	Against	Examine Individually
Supermajority proposals	1	25	5
Fair price proposals	7	15	9
Board classification	7	13	11
Blank check preferred stock	4	20	7
Reincorporation with anti-takeover provisions	3	19	9
Limitations on shareholders-rights	4	21	6

Source: Voting by Institutional Investors on Corporate Governance Questions: The 1984 Proxy Season, IRRC, 1984

Institutions report that they examine carefully and frequently vote against supermajority proposals, fair price proposals and classified board proposals. Widely publicized episodes in which corporations have used preferred stock to create poison pills and other shark repellents have made investment managers increasingly wary of approving so-called "blank check preferred stock." Many now regard authority to issue blank check preferred stock as a major antitakeover device, and many are voting against such authority. Two-thirds of the investment managers responding to our 1984 survey said they usually vote against such proposals, while a number of others said they put the burden on the management of each company to demonstrate the need for preferred stock.

In addition to surveying the voting policies of institutional investors, our firm also has obtained voting results for antitakeover charter amendments voted on during each of the last three years. During 1983 and 1984, we obtained voting results for proposals at more than 300 companies. Already this year, we have identified more than 130 companies that have put antitakeover proposals on the ballot. The overwhelming majority--more than 90 percent--of the proposals have been adopted. During 1984, for example, we found that only about a dozen of the more than 300 proposals voted on were voted down. So far in 1985, only five proposals for which we have results have failed to obtain the required levels of approval. Given the high levels of institutional ownership of many large companies, these results quite naturally raise questions about institutional voting practices.

If, as our surveys indicate, institutions are opposing antitakeover proposals, why are most of the proposals passing? Several observations seem warranted here. First, the investment managers that respond to our surveys are not necessarily representative of all investment managers, and in fact there is some reason to believe that they are unrepresentative. Their willingness to subscribe to our services, to take the time to answer our inquiries and to share information with us sets them apart from many other firms that have been less willing to devote time and resources to independent examination of the issues. Thus, the fact that some institutions are acting in a responsible manner should not obscure the fact that many others probably are not.

Second, our own survey results and conversations with proxy solicitors indicate that there is a relationship between firm size and voting policies: The larger the firm, the more likely it is to have independent voting policies. As noted previously, the investment managers that subscribe to our services are among the nation's largest.

Third, many corporations wishing to adopt shark repellents use proxy solicitation firms and public relations firms to estimate in advance the likelihood of winning approval. These advisers conduct an analysis of who owns a company's stock, and, in the case of institutions, how they are likely to vote. Proxy solicitors report that some companies never put shark repellents on the ballot because they know in advance that they are unlikely to gain approval. Although not all companies do this sort of screening, many do, and its use tends to result in higher levels of approval than otherwise would be the case.

Finally, although most proposals are passing, the level of opposition is nonetheless quite high at many companies. For example, even though most antitakeover proposals were approved in 1984, the level of opposition has been noteworthy at some of the larger companies that are widely held by institutional investors. At Bristol-Myers, 20.7 percent of the outstanding shares were voted against a classified board proposal, and 17 percent were voted against a fair price proposal. At Burroughs, 22.1 percent of the outstanding shares were voted against a reincorporation proposal containing a number of antitakeover proposals. A classified board proposal was opposed by 20.3 percent of the outstanding shares at Pitney Bowes, and at RCA, 18 percent of the shares entitled to vote were cast against a board classification proposal and 16 percent against a fair price proposal.

A majority of the outstanding shares entitled to vote is needed to approve antitakeover proposals at most companies. Thus, an abstention in most cases had the same effect as a "no" vote. If abstentions are added to "no" votes, the level of opposition to antitakeover proposals has been substantial at many companies.

20.9 percent against fair pricing at American Natural Resources in 1984; 27.8 percent against a classified board at Bristol-Myers; 27.2 percent against a reincorporation proposal with antitakeover features at Burroughs; 27.2 percent against a proposal at Georgia-Pacific to require a supermajority vote to repeal a board classification; 26.1 percent against a classified board proposal at Pitney Bowes; 18.9 percent against fair pricing at Koppers; 22.1 percent against board classification at Federated Department Stores; 23.8 percent against fair pricing, and 26.5 percent against board classification, at RCA; 17.3 percent against fair pricing at Ralston Purina; 17.6 percent against board classification and 16.2 percent against fair pricing at Texaco. This level of opposition is a reliable indicator of institutional opposition.

Policies of Plan Sponsors

Plan sponsors subject to ERISA have remained largely passive in the corporate governance process, with the notable exception of takeover battles in which plan sponsors have become either bidders or targets. A major reason for this passivity is the widespread use of outside investment managers by corporate pension funds. For example, according to the 1985 edition of *Money Market Directory*, 58 of the 100 largest corporate pension funds use outside investment managers exclusively. Of the 42 that use in-house management, many manage only cash and short-term commercial paper internally and rely on outside managers for equity investments. Among smaller pension funds, the use of outside managers is even more common for equity investments.

The common practice among plan sponsors using outside managers is to delegate to them responsibility for voting portfolio securities. In his 1977 study for the Congressional Research Service, Julius Allen found that even where plan sponsors manage a portion of their pension funds internally, they are likely to delegate voting to a trustee bank.[10]

Allen did identify several corporate pension funds that maintain voting responsibility. The three funds in his survey--General Electric, Sears, Roebuck and United States Steel--are among the 10 largest in the country. Of the three, GE had the most highly developed voting policies and procedures; GE said it gives portfolio managers considerable discretion in voting on certain items and requires proxy committee decisions on others. Sears reported that its policy was to support management or sell the stock in its portfolio. U.S. Steel indicated that it usually supported managements' positions but that there had been numerous instances in which it had done otherwise.[11]

After interviewing a number of pension fund officials and their managers, Allen concluded that there were two major reasons why corporate pension funds prefer to delegate voting responsibility to outside managers:

> One is the fundamental belief that it is sound policy for voting responsibility to be congruous with investment responsibility. If a bank trust department, insurance company or investment company is selected on the basis of its competence to make decisions on the equities in which fund assets are to be invested, it could be expected as well to have the related knowledge and judgment on how to vote the shares in the fund's portfolio in the best interests of the pension fund beneficiaries. Furthermore, pension fund officials may consider the voting of stock more in the nature of a nuisance or a chore that they have little or no interest in. Their interest may be strictly limited to the bottom line profits of their investment, and an indifference to other aspects of the management performance of

> portfolio companies or the issues that are submitted to stockholders at the companies' annual meetings or in their proxies. Also where a large pension fund portfolio may include common stocks of scores or even hundreds of corporations, it is understandable that fund officials may not want to take the time and effort to investigate the proxy issues that arise each year so as to vote in the considered interest of their fund beneficiaries. At least one pension fund official admitted to the author that having a bank vote the shares of its fund was essentially a matter of convenience and represented a kind of "cop-out," an unwillingness to get involved in a consideration of the issues in corporate proxy voting.[12]

Although Allen's report was completed almost eight years ago, his findings and conclusions appear to remain valid. It is noteworthy that no corporate pension funds testified at the Labor Department's January 1985 hearings on corporate governance. Furthermore, although several attended exploratory meetings in late 1984, no corporate pension funds have seen fit to join the newly formed Council of Institutional Investors. (See below.)

Of the more than 175 institutional investors that are clients of the Investor Responsibility Research Center, only two are corporate pension funds. Very few corporate pension funds have responded to our surveys on voting policies and practices. The few exceptions involve unique institutions, such as TIAA-CREF, or very large corporate pension funds with internal management. These funds have voting policies and practices that are similar in most respects to the policies of investment managers described above.

The major exception to the passive role adopted by corporate pension funds involves instances in which corporations have become either bidders or targets in hostile takeover attempts. This involvement can lead to the use of corporate pension funds, employee stock ownership plans (ESOPs) or other employee ownership plans in battles for control. As Grumman's use of an employee ownership plan several years ago to defend against a hostile takeover illustrates, this can create major conflicts of interest for corporate executives who also serve as plan trustees.[13]

Conflicts of Interest

Potential conflicts of interest are not uncommon for investment managers who must observe ERISA's fiduciary requirements and who also wish to cultivate good relations with existing and potential clients. As one witness at the Labor Department's 1985 corporate governance hearings noted:

> The investment manager retains his clients and earns his fees by delivering good performance, which is measured against market indexes at frequent intervals. No plan sponsor adds to the performance measures points for thoughtful consideration of corporate governance issues. On the other hand, voting portfolio shares against the antitakeover proposals of a present or prospective client is seldom perceived as the best way to cement or create a warm relationship.[14]

In addition to their responsibilities as fund managers, many banks and insurance companies have other relationships with corporations that create opportunities for conflict. Banks, for example, may serve as commercial lenders to, and insurance companies may be insurance underwriters for, companies whose pension funds they manage. Personal relationships among senior executives, including service on boards of directors of major customers, may introduce additional complications.

Reluctance to offend customers is frequently mentioned in the literature as one of the principal reasons why institutional investors traditionally have preferred to avoid making voting decisions that are opposed by the managements of portfolio companies. The appearance in proxy statements of antitakeover charter amendments and other items that may diminish the rights of shareholders or affect the value of their investments puts investment managers in a position where they may be required to choose between their fiduciary responsibilities and their own financial interests.

Testimony given at the Labor Department's corporate governance hearings in early 1985 suggests that some pension fund managers are putting other considerations ahead of the best interests of pension fund participants. One of the nation's most respected money managers, Dean LeBaron of Batterymarch, said at the hearings:

> Institutional investors have a poor record for statesmanlike behavior in protecting their interests in voting against limitations on their own rights as shareholders. I'm told that institutions have been voting more nearly in favor of limitations of their own rights this year. There may be short-sighted commercial reasons for doing so because any other explanation seems impossible. Perhaps there has been mild, friendly persuasion to encourage these votes. Certainly institutional investors have not been in the forefront in assuming a militant position in favor of their own rights.[15]

The hearings also produced evidence that corporations have exerted pressures on investment managers to support actions that may be contrary to the best interests of pension fund participants. David L. Heald, vice president and general counsel of First Chicago Investment Advisors, testified, "We have had certain situations where there were apparent threats...suggesting to us that if we proceeded with our particular position they might want to find another commercial banking arrangement."

A number of persons have reported to us that companies seeking shareholder approval of antitakeover charter amendments are becoming more aggressive in seeking shareholder ratification. In some cases their efforts have involved discussions with investment managers that attempt to convince them of the merits of the proposals, but in other cases companies have attempted to exert greater pressure on investment managers to support proposals.

These pressures seem to have intensified considerably within the last 18 months, as the number of major corporations seeking approval of antitakeover charter amendments has increased. We are not certain how frequently these pressures cause investment managers to support proposals that they otherwise would be inclined to oppose, but it would be naive to suppose that such instances are either nonexistent or uncommon. Even if corporate clients exert no direct pressure, the very existence of a business relationship may influence investment managers to put their own self-interest ahead of their fiduciary responsibilities.

The reluctance to offend clients may be one of the major reasons why antitakeover charter amendments are so rarely defeated, even at companies that have substantial institutional ownership.

Institutional Activism

There is little reason to suggest that private sector pension fund sponsors or fund managers will soon decide to take the initiative on corporate governance issues. Fund sponsors for the most part prefer to delegate decision-making on corporate governance matters to outside investment managers. Despite the willingness of some to vote against shark repellents, investment managers have no wish to become enmeshed in corporate decisionmaking, and they see no advantage to such action.

Although they are not subject to ERISA and the Labor Department's jurisdiction, the recent actions of public pension funds on corporate governance questions deserve some mention. In particular, the decision of a number of public pension funds to form a Council of Institutional Investors could serve as a catalyst for more active institutional investment. More than a dozen major public pension funds announced in early 1985 that they have joined the council, which will serve as a forum to raise corporate governance issues that affect member funds. Public funds are largely immune from the potential conflicts of interest and other business-related restraints that temper whatever activist instincts exist among ERISA plan sponsors and fund managers. Their very public nature makes public funds politically accountable for their actions on controversial issues, and the size of their holdings virtually assures that their actions will have some effect. Examples set by public funds could eventually give encouragement to other pension fund sponsors and managers.

The first meeting of the council suggests that it could prove to be a considerable force. At the council's invitation, major parties involved in the recent takeover battle for Phillips Petroleum met with council members in New York in February 1985. Council members questioned top Phillips executives, T. Boone Pickens Jr., Carl Icahn and others for the better part of a day. Many council members were highly skeptical of the defensive actions taken by Phillips in response to hostile takeover attempts by Pickens and Icahn. Phillips was unable to persuade many of the council members that a proposed recapitalization plan would benefit shareholders. Shortly after the meeting, shareholders of Phillips defeated the recapitalization plan when it was put to a vote.

If they decide to become more active, public funds and other institutional shareholders may elect to pursue a number of different courses of action, depending on the circumstances. One possibility is to lend active support to the efforts of other shareholders seeking to preserve shareholder rights. An instructive example is the support that a number of institutional investors gave to Willametta Keck Day's efforts in 1983 to require Superior Oil Co. to establish a committee of independent directors to review offers to purchase the company. Even though the resolution was vigorously opposed by Superior's management, it received the support of a majority of the shares voted. Institutional support is widely credited as having been responsible for the resolution's success and the company's subsequent decision to appoint such a committee.

A second possibility open to pension funds is to make their views known directly to management on proposed actions that affect shareholder rights. Again, an episode involving Superior Oil provides a good example: When the company announced in late 1983 that it intended to issue so-called poison pill warrants, opposition from institutional investors and intimations that they would support efforts to remove the management of the company led the company to reconsider its actions and to cancel the proposed issuance. Although the business and family circumstances involving Superior Oil may have been unique, both episodes nonetheless underscore the impact that institutional investors can have. Even where their efforts have been unsuccessful (1984's protests against greenmail at Texaco, for example), the willingness of institutional investors to speak out is not likely to go unnoticed.

A third possibility is for institutions to take the initiative in exercising their rights as owners. Shareholders have the right, for example, to have resolutions included in the proxy statements of their companies. Church groups and others have used this device to raise social and ethical issues. Individual proponents of shareholder rights, such as John and Lewis Gilbert, have used the proxy process for many years to raise corporate governance questions. Pension funds and other institutions could easily make use of this process to recommend the rescission of bylaw or charter amendments that serve to disenfranchise shareholders, or to urge the adoption of bylaw or charter amendments that would prohibit practices such as greenmail.

A fourth possibility would be to take legal action to prevent or reverse actions by incumbent directors and officers that violate the duty of care or the duty of loyalty that they owe to shareholders. While the business judgment rule makes it difficult to challenge successfully the actions of directors and officers, instances may occur that provide excellent opportunities to ask the courts to scrutinize more carefully the actions of officers and directors.

A fifth possibility would be to initiate or support efforts to replace incumbent directors when they have demonstrated by their actions a consistent disregard for the interests of shareholders.

Notes

1. Institutional Investor Study Report of the Securities and Exchange Commission, March 1971, Summary Volume, p. 125.

2. Staff Report on Corporate Accountability, Securities and Exchange Commission, September 1980, pp. 393-394.

3. The Exercise of Voting Rights By Large Institutional Investors: A Survey, Julius W. Allen, for the Congressional Research Service of the Library of Congress, December 1977. Printed by the Senate Governmental Affairs Subcommittee on Reports, Accounting and Management as Part II of a staff study entitled Voting Rights in Major Corporations, January 1978.

4. Staff Report on Corporate Accountability, op.cit., note 2, p. 395.

5. Ibid., p. 397.

6. Ibid., p. 397.

7. Voting Policies of Institutional Investors on Corporate Governance Issues, Investor Responsibility Research Center, December 1981.

8. Voting By Institutional Investors on Corporate Governance Questions: The 1983 Proxy Season, Investor Responsibility Research Center, October 1983.

9. Voting By Institutional Investors on Corporate Governance Questions: The 1984 Proxy Season, Investor Responsibility Research Center, September 1984.

10. Voting Rights in Major Corporations, op.cit., note 3, pp. 720-721.

11. Ibid., pp. 720-729.

12. Ibid., pp. 724-725.

13. See Donovan v. Bierwirth, 680 F.2d 263 (2nd Cir. 1982).

14. Testimony of Roger F. Murray, Corporate Governance Hearings, U.S. Department of Labor, Jan. 10, 1985.

15. Testimony of Dean LeBaron, Corporate Governance Hearings, U.S. Department of Labor, Jan. 10, 1985.

IV. PENSION FUNDS AND CONTESTS FOR CORPORATE CONTROL

The use of pension fund assets in contests for corporate control presents especially troublesome conflict-of-interest problems for pension fund sponsors, trustees and investment managers. Plan sponsors and trustees named by management may be tempted to use plan assets either to acquire the assets of other companies or to defend against hostile takeover attempts. Investment managers also face potential conflicts of interest in battles for corporate control. For example, a bank serving as trustee for an employee savings plan holding a substantial amount of stock in a corporation that becomes a target of a hostile takeover attempt may also have a close commercial banking relationship with the target company. The bank's fiduciary obligation to savings plan participants and its wish to maintain its banking relationship with the target company's management may create a potential conflict of interest. The growing popularity of employee stock ownership plans (ESOPs) and other employee ownership programs encouraged by recent changes in federal tax law is likely to mean that plan sponsors, trustees and financial intermediaries serving as trustees for such plans will be forced to confront such situtations more frequently in the future.

Actions of Plan Sponsors

The use of pension fund assets to acquire stock in a company that has become the target of a takeover may put plan sponsors and trustees in jeopardy of violating ERISA's fiduciary standards. The problems that can arise in this context were illustrated in a 1983 case, in which the Department of Labor brought suit against Harold C. Simmons and seven associates alleging that they had used the assets of several pension funds under their control to finance Simmons's acquisition efforts. Simmons controls Contran Corp. and nearly 30 affiliated businesses. Simmons and his co-defendents had sole investment authority for pension plans that had invested heavily in two companies taken over by Simmons, Keystone Industries and Amalgamated Sugar. The Simmons group obtained control of Keystone though pension fund investments and then applied Keystone's pension investments to advance a proxy contest for control of Amalgamated Sugar.

The Labor Department charged that Simmons and his associates used the assets of various benefit plans to advance their own personal and corporate interests in violation of ERISA requirements that they act solely in the interest of plan participants. The custodian for Keystone's plan, Jefferson Trust and Savings Bank, filed a similar suit against Simmons that was subsequently consolidated with the Labor Department suit. The Simmons group argued that their investment decisions have been profitable and greatly benefited participants of the affected pension plans. Pension funds controlled by Simmons also purchased substantial interests in several other companies, including Cyclops, Interpace and National Standard. Cyclops Corp. brought separate charges under the federal securities law claiming that the pension funds under Simmons's control had purchased Cyclops shares to gain control while failing to disclose this intention in documents he was required to file with the Securities and Exchange Commission.

A U.S. District Court granted a preliminary injunction to restrain the Keystone and other plans controlled by the Simmons group from stock purchases in companies in which they had invested more than 10 percent of plan assets or held more than 2 percent of the outstanding voting shares. Thereafter, the Labor Department and the Simmons group reached a settlement that: (1) appointed an independent fiduciary responsible for the management or sale of Amalgamated Sugar stock held by the plans, (2) enjoined two defendants, Simmons and his brother, from violating ERISA's fiduciary provisions, (3) dismissed claims against three defendants who had resigned as plan fiduciaries and agreed not to serve as fiduciaries of the affected plans for five years, (4) prohibited the defendants from creating a joint trust to hold assets of more than one of the affected plans or amending the plans contrary to the settlement. Simmons and the other defendants did not admit to any violation of ERISA.[1]

In the Simmons case the Labor Department advanced the position that fiduciaries must not make investment decisions in order to benefit themselves or their corporations. However, the department has not ruled out the possibility that fiduciaries may incidentally use pension plan investments, made solely to benefit plan participants, to support efforts to gain control of companies in which the plan invests.

Federal courts have issued a number of decisions that have considered the responsibilities of plan sponsors and trustees in contests for corporate control. These decisions establish strict standards of conduct for trustees and plan sponsors. The U.S. Court of Appeals for the Seventh Circuit, reversing a district court decision, found in 1984 that Clyde Engle, companies under his control and other defendents had violated ERISA fiduciary standards by investing pension plan monies in three companies that were takeover targets of the defendents. The court deemed it unlawful to place plans' assets at risk (regardless of ultimate profit) to further takeover aspirations of a party in interest to the plan, at least without neutral trustees or sufficient independent consideration of this use and other options.[2]

The court suggested several tests that should be applied in determining whether plan administrators acted "solely in the interest" of plan participants: (1) "risk of conflicts between the interests of the fiduciaries and beneficiaries," (2) "whether fiduciaries make an intensive and scrupulous investigation of the plan's investment options," and (3) the use of plan assets "in congruence with the fiduciaries' personal interests over a substantial period of time in control contests." Given the facts of the case, and the absence of an independent inquiry into the plan's investment choices, the court said it "need not decide whether the potential conflicts alone amounted to ERISA violations." It added that the central issue is the independence of the plan fiduciaries and their consideration of investments, and that congruence with one side or another in a takeover contests is not in itself a breach of duty.

The court emphasized: "The nature of the breach of fiduciary duty alleged here is not the loss of plan assets but instead the risking of the trust's assets at least in part to aid the defendants in their acquisition program....[P]laintiffs are not required to show that the trust lost money as a result of the alleged breaches of fiduciary duties." The court ruled that, as in this case, "If ERISA fiduciaries breach their duties by risking trust assets for their own purposes, beneficiaries may recover the fiduciaries' profits made by misuse of plan assets." The court found that there are only limited exceptions where ERISA would permit fiduciaries to act in situations where their interests and those of plan beneficiaries may diverge.

It is significant that the court chose to apply to the Engle dispute the "prohibited transactions" standards of ERISA [Section 406] forbidding use of plan assets to benefit a "party in interest" or to serve a fiduciary's "own interest." The court found that ERISA's prohibition against actions by fiduciaries in their "own interest" must be interpreted to include an interest in corporate control regardless of direct financial interests:

> Thus, in a contest for corporate control, plan trustees who are also officers of either the 'target' or the 'raider' could be seen as having a significant 'interest' of their own in the outcome of the contest. Officers of the 'target' might well be immediately concerned about holding onto their jobs. Officers of the 'raider' might find it in their interest, in terms of maintaining good relations with their superiors, for example, to assist their corporation in its acquisition efforts.

The court also said it views "favorably the suggestion of the Secretary of Labor, as amicus curiae, that the preferred course of action for a fiduciary of a plan holding or acquiring stock of a target, who is also an officer, director or employee of a party-in-interest seeking to acquire or retain control, is to resign and clear the way for the appointment of a genuinely neutral trustee to manage the assets involved in the control contest. Otherwise, the risk is too great that the trustee will come to a crossroads where the interests of the plan and the party-in-interest diverge. For example, while the party-in-interest may be seeking to accumulate as many shares as possible in order to maintain or acquire control, a plan's interest in maximizing its investment return may require it to tender its shares to a competing bidder for shares."

Pension fund assets also may be used defensively to deter hostile takeovers and proxy contests in several ways--primarily to purchase company stock, vote shares with managements, or assist in financing a management buyout. ERISA fudiciaries must exercise caution in such cases because they are required by ERISA to formulate pension plan actions with an "eye single" to the interests of plan participants.

The federal courts have concurred with the Department of Labor's view that pension assets may not be used to protect a company and its management from a change in control. The leading case, Donovan v. Bierwirth,[3] involved Grumman's use of an employee benefit plan's assets to defend against a hostile takeover attempt by LTV. In that case, the U.S. Court of Appeals for the Second Circuit examined how corporate officers who served as pension fund trustees used pension assets to acquire a large proportion of Grumman common stock through open market purchases. As a result, LTV's bid to acquire Grumman was defeated. The court ruled:

> Although officers of a corporation who are trustees of its pension plan do not violate their duties as trustees by taking action which, after careful and impartial in-

> vestigation, they reasonably conclude best to promote the interests of participants and beneficiaries simply because it incidentally benefits the corporation or, indeed, themselves, their decisions must be made with an eye single to the interests of the participants and beneficiaries. This, in turn, imposes a duty on the trustees to avoid placing themselves in a position where their acts as officers or directors of the corporation will prevent their functioning with the complete loyalty to participants demanded of them as trustees of a pension plan.

The court found that the trustees of the Grumman plan failed to undertake a sufficiently thorough, careful and objective investigation to justify their actions:

> They should have realized that, since their judgment on this score could scarcely be unbiased, at the least they were bound to take every feasible precaution to see that they had carefully considered the other side, to free themselves, if indeed this was humanly possible, from any taint of the quick negative reaction characteristic of targets of hostile tender offers displayed at [their] board meeting, and particularly to consider the huge risks attendant on purchasing additional Grumman shares at a price substantially elevated by the tender offer.

The court found that the Grumman plan trustees failed to investigate fully the tender offer and to consider the "huge risks attendant on purchasing additional Grumman shares at a price substantially elevated by the tender offer." As an alternative, the court said that the trustees should have appointed neutral trustees because decisions on purchasing the stock, as well as holding it during a contest for control, put the corporate officers in an "almost impossible" conflict of interest.

The court rejected the defendants' justification that defeat of the LTV offer would run counter to the interests of the beneficiaries and that therefore the fund should therefore try to stop the offer. The court also dismissed the defense that LTV might damage the Grumman pension plan, saying the defendants had failed to study the matter adequately and "were bound to take LTV up on its statements [that it did not intend to touch the plan] and see how far, if at all, it was willing to place these in binding form."

Actions of Financial Intermediaries

The actions of financial intermediaries, as managers and as trustees, are subject to the same fiduciary standards that apply to plan sponsors. In 1984 the Labor Department warned BankAmerica, trustee for the profit-sharing retirement and income plan for employees of Carter Hawley Hale, of potential violations of ERISA's fiduciary requirements. At the time, Carter Hawley Hale was defending against a hostile tender offer by The Limited. The retirement plan for which BankAmerica served as trustee held about 15 percent of Carter Hawley Hale's stock, a position large enough to influence the outcome of the takeover battle. Certain provisions of the trust agreement between Carter Hawley Hale and BankAmerica sought to limit the responsibilities and obligations of the trustee by, among other things, giving individual participants a voice in decisionmaking, including decisions whether to tender shares to a bidder seeking control of a company in the plan's portfolio.

Such a plan, the Labor Department wrote attorneys for BankAmerica, would not be lawful if it prescribed a course of action that is inconsistent with ERISA's requirements. Regarding decisions by plan participants, the department advised:

> Situations where a procedure for obtaining instructions from participants could lawfully be put into effect would occur only where the trustee had determined that

> the participants had in fact rendered an independent decision in directing the trustee, without pressure from their employer as to how to vote their shares. Therefore, the trustee would remain responsible for such matters as assuring that the plan's provisions are fairly implemented, that necessary information is provided to participants, that clearly false or misleading information is not distributed to participants (or to correct any such false or misleading information that may have been distributed to participants by other parties) and would also remain responsible for determining whether following participant directions would result in a violation...of ERISA. In our view, therefore, if, among other things, the participants-employees are subjected to pressure from the employer to vote their shares in a particular manner, it would be the duty of the trustee to ignore any direction given which is the result of such pressure, as it could not be considered "proper direction."[4]

The department warned BankAmerica that it should not give effect to a plan provision that would permit a participant who had not issued a specific instruction to be deemed to have issued such an instruction, nor should it give effect to a participant's instruction to reverse a previous instruction in order to comply with the directions of a majority of plan participants. Finally, it stated its belief "that the fiduciary duties of ERISA would require the trustees to consider whether the plan has any claims under ERISA, the securities laws, or other law arising from the conduct of any party in connection with the tender offer, and, if appropriate, to take action to assert those claims."

"Of course," the department concluded, "in this case, as in all matters, trustees must ascertain whether existing or potential conflicts of interest may interfere with the proper exercise of these responsibilities."

The Labor Department did not file any action in court against BankAmerica, although it did prepare a draft complaint. It is unclear whether the courts would accept the department's position.

The episode does, however, illustrate the issues that financial institutions face in hostile takeover situations. The existence of other business relationships--BankAmerica also had a commercial banking relationship with Carter Hawley Hale--may create serious conflict-of-interest problems.

Similar difficulties may arise when plans must vote on proxy contests for control. Fiduciaries remain bound to ERISA requirements that they examine their choices prudently and with the sole interest of plan participants and beneficiaries in mind.

Employee Stock Ownership Plans

The number of corporations establishing employee stock ownership plans (ESOPs) has grown dramatically in recent years. By one recent estimate 7,000 companies have adopted ESOPs, covering approximately 10 million workers, compared with only about 500,000 workers a decade ago.[5] Favorable tax treatment and the improvement of employee loyalty, morale and productivity are among the major reasons for the explosive growth of ESOPs.

ESOPs also are a potent antitakeover device. They put large amounts of stock in the hands of employees, who usually can be counted on to support incumbent management in a contest for corporate control. Moreover, in many instances, voting control of stocks held by ESOPs rests not with individual employees but with trustees appointed by the incumbent management. Frequently, these trustees serve as top corporate officers.

Their tax-favored status also makes it possible for ESOPs to borrow funds on favorable terms, and this has encouraged the use of ESOPs to conduct leveraged buyouts. A growing number of employee groups in the last few years have arranged leveraged buyouts that involve the creation of ESOPs or the termination of other employee benefit plans. Like other leveraged buyouts, ESOP buyouts often serve as "preventive medicine" to avoid possible takeover attempts, or, as in the employee buyout of Weirton Steel, as one of the last resorts in revitalizing a troubled business.

Some companies have prepared ESOP buyouts as an antitakeover response to stock accumulations by individual investors such as Carl Icahn (Dan River), T. Boone Pickens (Phillips Petroleum) and Victor Posner (National Can) or by corporations (Amstar in response to Simplicity Pattern). At least one company has prepared a leveraged buyout using an ESOP following a two-tier tender offer (HMW Industies in response to Clabir Corp.). Harper & Row terminated a defined benefit plan and used the proceeds to establish an ESOP, which in turn bought out a large block of stock held by a holder friendly to incumbent management. U.S. Sugar also bought out most of its majority holder through a unique joint tender by the corporation and a newly formed ESOP. In both cases, sales of controlling blocks of stock to third parties rather than the ESOPs might have created a situation favoring a change in corporate control.

The use of ESOPs to conduct leveraged buyouts or to thwart hostile takeover attempts is fraught with potential conflicts of interest. The primary motivation of corporations establishing ESOPs in such circumstances is frequently to prevent a change in corporate control. Yet ERISA requires that ESOPs, like other retirement plans, be administered solely for the benefit of employees. Given the effects that these potential conflicts of interest may have on employees, the establishment of ESOPs, particularly in the context of a threatened change in corporate control, deserves the careful scrutiny that it appears to be receiving by the Labor Department.

Notes

1. See BNA Pension Reporter, Vol. 10, p. 851, May 16, 1983.
2. Leigh v. Engle, 727 F 2d 113 (7th Cir. 1984).
3. Donovan v. Bierwirth, 680 F 2d 263 (2nd Cir. 1983).
4. Office of Pension and Welfare Benefit Programs, Opinion Letter re: Profit-Sharing Retirement Income Plan for the Employees of Carter Hawley Hale Stores Inc., April 30, 1984.
5. "ESOPs: Revolution on Ripoff," Business Week, April 15, 1985, p. 94.

V. CONCLUSIONS

Some observers have suggested that the current corporate governance model no longer corresponds to economic reality and that shareholders today have few if any of the attributes of real ownership. More than 50 years ago, Adolph Berle and Gardiner Means called attention to the growing separation of ownership and control resulting from the growth in size of corporations, the rise of professional managers and the development of modern capital markets. One consequence, they noted, was the passivity of shareholders and their virtural disenfranchisement. Writing in the 1959 classic, The Corporation in Modern Society, economist Edward S. Mason likened the shareholder of public corporations to the bondholder, "a functionless rentier." In the same volume, Harvard Law School Professor Abram Chayes characterized the shareholder as "an investor, separated in time and understanding, insulated by distance and the proxy machinery from the business activities of the enterprise," largely unaffected by the corporation's actions, with little legitimate claim to exercise a voice in corporate decision-making.

No alternative model of corporate governance has yet been developed, however. The most frequently discussed alternatives, which call for a greater voice in corporate affairs for employees, government and other nonstockholder groups, have failed so far to win widespread public support, and they have generated strong opposition, particularly within the corporate world. Theoretically and practically, shareholders remain important participants in the corporate governance process. Our system of corporation law still considers shareholders to be owners. Their rights of ownership, including the right to participate in corporate decision-making, are protected by the courts, government agencies and quasipublic institutions such as the New York Stock Exchange.

Developments of the last decade have thrust pension funds into the corporate governance system in ways that few could have imagined when the Employment Retirement Income Security Act was adopted in 1974. The growth in the size of pension fund assets, and the investment of sizable amounts of these funds in common stocks, have made pension funds major owners of corporations. At the same time, the development of corporate governance issues that can affect the rights of shareholders and the value of their investments means that pension funds, their investment managers, and others who act as fiduciaries must carefully consider current corporate governance issues if they are to meet their responsibilities.

The continued growth in pension fund assets suggests that issues such as those discussed in this paper are likely to assume even greater importance in the future.

As the executive department of the federal government that is principally responsible for administration and enforcement of ERISA, the Department of Labor has a critical role to play in assuring that pension fund sponsors, managers and other fiduciaries comply with ERISA's requirements. As part of this responsibility, there are several actions which the department may wish to consider regarding the involvement of pension funds in the corporate governance process. The proposed actions are for the most part self-executing, they present minimal burdens for pension fund sponsors and managers, and they would promote compliance with the objectives of ERISA without straining the limited resources of government.

- First, the Department of Labor may wish to consider issuing a policy statement on the subject of pension funds and corporate governance issues. Robert A.G. Monks, former administrator of the Office of Pension Welfare Benefit Programs, gave a number of speeches on the subject while in office that helped to raise consciousness about the issues among fund sponsors and managers. The department also has used enforcement actions to shape policy. It may be appropriate now for the department to develop a statement of policy setting forth its views on the responsibilities of ERISA fiduciaries in regard to corporate governance issues. The statement might include matters such as voting on corporate governance issues and the activities of fiduciaries in regard to contests for corporate control. Such a statement would serve as notice to ERISA fiduciaries that the department considers careful attention to corporate governance issues to be a consequential matter, and it also would provide guidance to plan sponsors, trustees and investment managers.

- Second, there is a need for more complete data about the activities of pension funds in regard to corporate governance issues. Information gathered by the Securities and Exchange Commission for its study of institutional investors, published in 1971, and the study conducted for the Senate Government Affairs

Subcommittee on Reports, Accounting and Management in 1977, predate the emergence of corporate governance issues as matters of concern for public funds, and the SEC study even predates the enactment of ERISA. The Investor Responsibility Research Center's more recent surveys provide insights into the policies of major institutional investors, but there is a need for information about the policies of a broader spectrum of investment managers. Very little information is available about pension fund sponsors; although it appears that most pension fund sponsors delegate responsibility for decision-making on corporate governance issues to their outside investment managers, there is almost no recent empirical evidence about their policies. To remedy these deficiencies, the Department of Labor may wish to consider conducting its own survey of ERISA fiduciaries, including plan sponsors, trustees and investment managers.

- Third, the Department of Labor may wish to consider requiring pension fund sponsors and managers to disclose publicly their voting policies and procedures on corporate governance issues. This would give the department and other interested parties much needed information. It also would serve to promote compliance by fund sponsors and managers with ERISA's requirements. The Securities and Exchange Commission has made excellent use of disclosure requirements over the years to encourage compliance with the federal securities laws. Among other things, it now requires institutional investors with substantial assets under management to disclose their holdings publicly on a quarterly basis, and it also requires individuals acquiring 5 percent or more of a company's stock to disclose the purpose of their acquisition and to provide other information to the public. Certainly on the question of voting, and perhaps on other issues as well, public disclosure requirements would encourage compliance with ERISA's objectives.

- Finally, the Department of Labor should examine the division of decision-making authority on corporate governance issues among pension plan sponsors and their outside managers. In the matter of voting rights, the common practice of plan sponsors has been to delegate voting responsibility to outside managers. Several witnesses at the Labor Department's January 1985 hearings suggested that voting should be the responsibility of plan sponsors. It was suggested that this would place responsibility closer to the beneficial owners, whose interests are at stake, and that it would relieve financial intermediaries of the conflicts of interest that they often face in voting or in making other decisions related to contests for corporate control. While the idea of shifting responsibility onto the shoulders of plan sponsors may have merit, there are a number of questions to be considered. Given the apparent indifference of plan sponsors to the idea, is it reasonable to expect that they will conscientiously discharge their responsibilities? Do plan sponsors, particularly the sponsors of smaller plans, have the resources to assume these responsibilities? Are plan sponsors any less likely to be burdened by conflicts of interest than outside managers? Are they any more likely to resolve potential conflicts of interest in favor of plan participants? If plan sponsors are to assume full responsibility for corporate governance issues, is it advisable to require the use of independent advisers, nonmanagement trustees or employee representatives to assure that the interests of plan participants are protected? These and perhaps other issues need careful exploration before any action is taken.

UNITED STATES GENERAL ACCOUNTING OFFICE
WASHINGTON, D.C. 20548

HUMAN RESOURCES
DIVISION

June 24, 1985

B-219199

The Honorable William S. Cohen
Chairman, Subcommittee on Oversight
of Government Management
Committee on Governmental Affairs
United States Senate

Dear Mr. Chairman:

Subject: Interim Report on the Department of Labor's Management of the ERISA Enforcement Program (GAO/HRD-85-82)

As requested by the Subcommittee, we are providing information from our ongoing general management review of the Department of Labor on the management of the Employee Retirement Income Security Act of 1974 (ERISA) enforcement program to assist the Subcommittee in its oversight hearings on implementation of ERISA.

The objectives of our overall management review are to determine how well Labor is organized and managed to (1) identify and handle emerging issues, (2) efficiently and effectively implement programs, and (3) provide business-like functional support systems, such as financial management and procurement. We chose the ERISA enforcement program as a case study for our overall review to assess, among other factors, the extent to which problems in management direction or control contributed to longstanding criticisms of the program.

We reviewed previously issued reports on the enforcement program and interviewed program officials in headquarters and 3 of 10 area offices (Atlanta, Chicago, and Dallas) to obtain their views on program operations and problems. As part of our overall review, we sent questionnaires to 10 managers involved in the program to obtain their perceptions on Labor Department management in general. We also analyzed program policy and strategy documents and selected program performance data. The Internal Revenue Service, the Department of Justice, and the Pension Benefit Guaranty Corporation also have roles to play in implementing certain ERISA provisions, but we did not include them in our review. Our work was performed in accordance with generally accepted government auditing standards.

(203511)

Although much of the information has been previously reported by us or others, we did not request Labor to review and comment officially on a draft of this report. However, the views of directly responsible officials were sought during our work and are incorporated in the report, where appropriate. We plan to obtain official comments from Labor on our overall report on Labor management, which will include the observations discussed in this interim report, as appropriate.

ERISA was passed to help ensure that employees who are covered by private pension and welfare plans receive the benefits to which they are entitled from these plans. Labor, specifically the Office of Pension and Welfare Benefit Programs (OPWBP), is responsible for enforcing ERISA's reporting, disclosure, and fiduciary provisions. According to Labor, OPWBP's overall fiscal year 1985 funding level is estimated at $29 million, and it has about 500 employees. Within OPWBP, the Office of Enforcement is responsible for providing policy, guidance, and direction to the field offices, which investigate the plans' compliance with the law.

LACK OF ASSURANCE THAT PROGRAM PROTECTS PARTICIPANTS

OPWBP's enforcement efforts have produced both monetary and nonmonetary results. For example, in fiscal year 1984, OPWBP reported closing 2,454 cases, of which 1,378 involved violations. Of the 1,378 cases, 383 involved $93 million in assets recovered or safeguarded under ERISA. To illustrate the types of problems identified in one recent case, OPWBP found that managers of a pension plan had engaged in a transaction prohibited under ERISA involving the purchase of an office building and other property from a sponsoring company and required that the property be sold, and funds be restored to the plan. In other examples, OPWBP required a plan to obtain sufficient bonding after it had found that the bonding initially secured by plan managers was inadequate and in another plan required that funds be restored to it after finding that plan managers had made an inappropriate loan.

Despite these accomplishments, the overall effectiveness of the program in protecting plan participants' benefits has been criticized over the last 10 years by a number of organizations, including GAO, Labor's Inspector General, and an internal Labor work group--the ERISA Enforcement Working Group--consisting of staff representing OPWBP, the Solicitor, and the Inspector General. In 1984, this work group reported that ERISA's enforcement program was unable to maintain credibility within the employee benefit plan community because there was no assurance that ERISA violations would likely be detected and corrected.

Longstanding problems in enforcing ERISA include (1) lack of a consistent long-term strategy; (2) limited coverage of benefit plans due to a small investigation staff relative to the number of plans to be monitored and the number of participants and amount of funds to be protected; and (3) inadequate staff training. Although Labor has recently taken action to improve the enforcement program, such as significantly enhancing OPWBP's organizational alignment, certain longstanding problems persist. We believe these problems largely center on the lack of a comprehensive, long-term enforcement strategy, which, when coupled with frequent turnover of key program officials, resulted in a reactive rather than a proactive approach to enforcement.

A brief discussion of the key problems we believe adversely affect program effectiveness and credibility follows.

LACK OF A CONSISTENT LONG-TERM STRATEGY

An effective strategy for enforcing ERISA and selecting plans for review is critical to achieve an effective program, particularly given the small number of investigators and large number of plans covered under the law. It is also important for determining the types of staff skills and training necessary since different types of plans would likely require different knowledge and expertise. Despite the importance of this, Labor has not had a comprehensive and consistent long-term strategy for enforcing the law or selecting plans for review. As a result, OPWBP does not have adequate assurance that plans most likely to be in violation of ERISA were being selected or that its limited resources have been most effectively applied.

Labor acknowledges that its approach to enforcement of ERISA has changed frequently over the years, largely in response to several internal and external reports criticizing how it was carrying out its mission. At its inception, ERISA enforcement emphasized technical assistance and program education. Then, as a result of two external reports in 1977 and 1978, the enforcement policy was redirected to fiduciary investigations with an emphasis on large employee benefit plans. In response to the criticisms of three additional reports issued in 1981 and 1982, the enforcement policy was again redirected in 1983 to give greater emphasis to criminal investigations, smaller plans, and consideration of ERISA violations other than fiduciary violations.

OPWBP has communicated its enforcement strategy through a Compliance Strategy Document. However, the document does not provide specific direction to the field offices on how to identify plans with the most potential for violations. Therefore, field offices developed their own methods for plan selection, resulting in wide variations in methods used and results achieved.

In 1978, we reported (HRD-78-154) that two field offices we reviewed used inconsistent bases for selecting plans to audit, and we said that better methods for selecting plans, such as random sampling, were needed. Labor's Inspector General made similar observations in a 1984 survey on ERISA enforcement. The Inspector General reported:

--Plan selection methods were inconsistent among the eight field offices visited, and responsibility for plan selection rested with supervisors in some offices and individual investigators or auditors in others.

--The success of case selection methods used by field offices varied widely. The percentage of unsuccessful cases (cases with no violations detected) varied widely among all field offices, ranging in fiscal year 1983 from 35 to 93 percent.

--Only two of the eight field offices reviewed had analyzed the effectiveness of their case selection methods.

The results of our current review of the ERISA enforcement program were similar to those reported by GAO in 1978 and the Inspector General in 1984. The three area offices we reviewed used different bases for case selection, and only one of the three had attempted to evaluate the effectiveness of its methods.

Another reason why development of and adherence to a sound long-term strategy is important in the pension program is because of the frequent turnover of key program officials. For the 10-year period that OPWBP was a part of the Labor-Management Services Administration, there were five Assistant Secretaries. Since 1974, there have been seven Administrators of OPWBP and eight Assistant Administrators of the Office of Enforcement. The adverse effects of this turnover were alluded to by the ERISA Enforcement Working Group, which reported that throughout the program's history, no consistent enforcement policy has been maintained beyond the tenure of the person with primary responsibility for implementing it.

In 1985, OPWBP developed a long-term plan with goals and objectives for each of its units. Although the Office of Enforcement's portion of the plan sets objectives only for the short-term--fiscal years 1985 and 1986--the Assistant Administrator agreed that long-term planning is a good management tool for establishing and maintaining program direction. He explained that he wrote short-term objectives because he had been in his position for only about a month and he needed more time in his position before he could develop effective long-term objectives.

Regarding program strategy and case selection methods, the Office of Enforcement's Assistant Administrator believes an effective enforcement program should focus its resources on as many plans as possible with an emphasis on detecting violations to make its enforcement presence known to the pension plan community. To achieve this type of program, he said the field offices should use a mixture of strategies to identify plans, including picking plans at random, reviewing plan data reported annually, and responding to complaints. Although he believes field offices should have the authority to manage their own casework, he agrees they should not be using inconsistent bases to select plans for review. In addition, he said his office had planned to develop a new Compliance Strategy Document in 1985, but he was uncertain as to when the document would be completed and whether it would specify case selection methods to be used by the field offices.

SMALL STAFF SIZE RELATIVE TO PLAN UNIVERSE

The number of investigators and auditors has enabled OPWBP to review about 2,400 plans annually, or less than 1 percent of the universe each year. According to Labor, as of 1984, there were about 915,000 pension and 4.6 million welfare plans covered by ERISA. These plans involved 266 million participants (many persons were covered by more than one plan) and over $900 billion in assets. To carry out its investigation function, OPWBP's personnel ceiling for fiscal years 1985 and 1986 included 253 investigator and auditor positions. According to Labor, as of June 1985, OPWBP has about 200 investigators and auditors, or about 1 for every 4,500 pension plans.

In 1978 (HRD-78-154), we reported that staffing of ERISA enforcement was inadequate to detect and investigate criminal and civil violations and recommended that the Secretary of Labor determine the additional resources needed to effectively enforce the act. Over the last several years, ERISA program staff have identified the need for additional resources, but the total number of investigators and auditors for the program has not changed substantially although the number of pension plans reporting has increased.

LIMITED TRAINING FOR ENFORCEMENT STAFF

Since 1977, the training provided for ERISA professional staff has been criticized for being limited and inadequate. As we reported 7 years ago, training for professional staff still consists of primarily on-the-job activities and little, if any, formal classroom training. According to Labor's 1984 report on ERISA enforcement, only four nationally sponsored training courses have been prepared since the program was established in 1974.

During our current review, 12 of 14 OPWBP program managers in both the field offices and headquarters indicated that they did not believe Labor's professional training and development programs have been effective in improving employee performance. Furthermore, OPWBP managers were among the least satisfied with Labor's training programs for professionals and supervisors of all the major Labor components we recently surveyed. Most of the OPWBP managers we interviewed said the lack of adequate training affects their operations. For example, several said the quality of their staff work would improve if adequate training was provided on such issues as real estate, banking, and financial investing.

OPWBP's Office of Enforcement has recognized the problems in the training area and plans to develop a comprehensive training program in 1985. It plans to address the development of investigators' technical skills and updating of their knowledge in rapidly changing areas, such as those cited above.

RECENT INITIATIVES TAKEN TO IMPROVE ERISA ENFORCEMENT

Labor has taken several recent steps to address a number of the longstanding problems associated with ERISA enforcement. For example, in 1984 the Secretary of Labor designated OPWBP as a separate agency reporting directly to him to help resolve some of its management problems due to its organizational structure. In addition, OPWBP made several internal organizational realignments to more effectively use its resources. It restructured the headquarters office to be more responsive to program needs, abolished the regional level to give the headquarters office more control over the field offices, and consolidated field offices to more effectively allocate its resources. In addition, Labor acted to improve the OPWBP working relationships with the Solicitor's Office. For example, three regional solicitors now have the authority to handle ERISA litigation matters to help expedite enforcement efforts.

CONCLUSIONS

The corrective actions Labor is planning, has started, or has completed to address many of the longstanding problems associated with its ERISA enforcement program should help enhance program effectiveness and credibility. Some of OPWBP's longstanding problems, such as staffing levels and frequent turnover of key program managers, are difficult to resolve and involve issues Labor itself cannot totally control.

However, we believe that much of the criticism of the effectiveness of the ERISA enforcement program could be overcome if OPWBP were to develop and follow a comprehensive long-term enforcement strategy. This strategy should include such elements as specific goals and objectives to be achieved over a multi-year period; specific approaches to be used, including case selection methods, to meet the goals and objectives; how training problems will be addressed; and how progress and results will be evaluated. The strategy could also discuss various approaches that could be followed with alternative resource levels and the results likely to be achieved under each alternative.

RECOMMENDATIONS TO THE SECRETARY OF LABOR

We recommend that the Secretary (1) direct OPWBP to develop a comprehensive, long-term enforcement strategy, (2) periodically track progress, and (3) hold key program managers accountable for adhering to the strategy and producing results unless changes are adequately justified and approved.

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We trust that this information will be helpful to the Subcommittee, and we would be pleased to discuss these matters with you or your staff. We are sending copies of this report to the Secretary of Labor and other interested parties.

Sincerely yours,

Richard L. Fogel

Richard L. Fogel
Director

Office of Inspector General

U.S. Department of Labor
Office of Audit

RECOMMENDATIONS
FOR LMSA
REORGANIZATION

Office of Audit

OFFICE OF INSPECTOR GENERAL

RECOMMENDATIONS
FOR LMSA
REORGANIZATION

Office of Inspector General

March 22, 1984

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EXECUTIVE SUMMARY

This report is the result of a limited survey of the Labor-Management Services Administration's (LMSA's) operations by the U.S. Department of Labor, Office of Inspector General (OIG). OIG staff has surveyed LMSA to gain an understanding of the Agency, to identify major audit issues, and to evaluate areas of concern to determine if they merit additional audit effort.

We concentrated on two major enforcement programs operated by the Agency: the Labor-Management Standards Enforcement (LMSE) and the Pension and Welfare Benefit Programs (PWBP). LMSE is responsible for protecting the rights of union members through enforcement of the Labor-Management Reporting and Disclosure Act (LMRDA). PWBP protects employee benefit plan assets and the rights of plan members through enforcement of the Employee Retirement Income Security Act (ERISA).

As this survey neared completion, the Secretary of Labor signed an order separating PWBP and LMSE into two distinct organizations. This survey report was written to provide timely information for the reorganization process.

From our work with LMSA, we have concluded problems exist with LMSA's enforcement efforts. We believe difficulties experienced by the Agency are the result of implementing strategies without evaluating enforcement needs and without clearly defining enforcement objectives.

LMSE

LMSE's primary enforcement tool, the Compliance Audit Program (CAP), is intended to detect serious violations of the LMRDA. It was instituted without adequately evaluating the need for a criminal detection program, or proper testing of its effectiveness.

It has not been successful. Since inception of the CAP in 1980, LMSE's statistics indicate that of the 2701 audits conducted through September 30, 1983, only 25 convictions resulted; a figure which we believe is inflated. Further, while the CAP uncovers other violations of the LMRDA, enforcement follow-up is not sufficient for problems to be corrected.

LMSE relies on the LMRDA's reporting and disclosure mandates to inform union members of union financial activities and obtain information to uncover and correct abuses. However, approximately 60 percent (30,000) of unions are delinquent in filing required reports each year. In addition LMSE does not have adequate procedures to pursue delinquent filers, or to obtain correct information when inaccurate union reports are submitted.

PWBP

Although good has come from PWBP's efforts to protect employee benefit plan members and plan assets, several factors have reduced the effectiveness of what may have been achieved. PWBP has not adequately defined its enforcement strategy or objectives. As a result, enforcement priorities and audit selection criteria are inconsistent, and their effectiveness has not been properly evaluated.

PWBP relies on information obtained from ERISA reporting requirements to assure plan participants are aware of their rights and responsibilities, involve participants in plan financial affairs, and augment PWBP's enforcement efforts. The information provided plan participants is often inaccurate and self contradictory. In addition, PWBP has not obtained current, reliable information for either public disclosure or its own enforcement needs. Finally, PWBP has not made effective use of plan financial audits completed by independent public accountants.

We are recommending that the enforcement needs, resource requirements, and strategies of both LMSE and PWBP be re-evaluated. We are also recommending that LMSE's Compliance Audit Program and PWBP's computer assisted targeting experiments, which have proven ineffective, be limited pending the results of the evaluation recommendations.

Although not part of our survey objectives, we are also providing information on organizational structure, which we feel merits attention because of the pending reorganization of LMSA. Specifically, we believe LMSA's organization has:

- duplicative and unnecessary functions;
- ineffective levels of enforcement review; and
- a field office structure which requires evaluation prior to reorganization.

PURPOSE

OIG staff has reviewed the Labor-Management Services Administration (LMSA) to gain an understanding of the Agency, to identify major audit issues, and to survey areas of concern to determine if they merit additional audit effort.

As this review was near completion, Secretary's Order 1-84 issued January 20, 1984 terminated the assignment of the Pension and Welfare Benefit Program to the Assistant Secretary for Labor-Management Relations and established the Office of Pension and Welfare Benefit Programs (OPWBP) as a separate agency within the Department effective within 120 days. The Secretary of Labor further established an Executive Steering Group for the Establishment of OPWBP to facilitate the transition. Other working groups have also been established including an Enforcement Working Group. The OIG will participate on both the Executive Steering Group and the Enforcement Working Group.

This paper summarizes findings of this limited OIG review. It is designed to provide the Executive Steering Group and the Enforcement Working Group with what we consider to be the major concerns with LMSA's enforcement activities which can be addressed by the impending reorganization. It contains our recommendations for redirection of staff and program activities.

BACKGROUND

LEGISLATION

There are two major Federal statutes for which LMSA has enforcement responsibility: the Labor-Management Reporting and Disclosure Act of 1959 (LMRDA) and the Employee Retirement Income Security Act of 1974 (ERISA).

- The objective of the LMRDA is protection of the rights of union members. This is accomplished by assuring that union elections are fair, union members are provided the information needed to be aware of their union's financial activities, and misuses of union funds are corrected.
- The objectives of the ERISA are protection of employee benefit plan assets, and the rights of the individual plan members and their beneficiaries.

ORGANIZATION

The LMSA has been given primary responsibility for the enforcement of the LMRDA. It shares responsibilities for enforcement, and reporting and disclosure of the ERISA with the Internal Revenue Service and the Pension Benefit Guaranty Corporation (PBGC). PBGC is a corporation established by Congress to provide for payment of pension benefits in the event of financial failure of certain types of plans.

LMSA's responsibilities encompass approximately 50,000 unions controlling about $6 billion in assets. To enforce these responsibilities LMSE:

1. Collects reports from unions and makes the information available to the public.
2. Investigates union election complaints and oversees any necessary reruns of elections.
3. Investigates possible criminal or civil violations of the Act.

LMSA also has oversight responsibility for the assets contained in employee benefit plans. FY 1981 estimates placed the number of such plans at 751,000 with assets totaling $ 550 billion. To enforce its employee benefit plan responsibilities PWBP:

1. Assures public disclosure of employee benefit plan reports and plan documents.

2. Audits to uncover civil fiduciary violations or prohibited transactions.

3. Investigates possible criminal misuse of employee benefit plan funds.

LMSA's organization to manage these responsibilities has changed over time in response to changes in legislation and in administrative decisions.

- In 1959, the Bureau of Labor-Management Reports was established to enforce the LMRDA through five regional and 24 area offices.

- In 1963, the Labor-Management Services Administration was created, consolidating the Secretary's labor-management responsibilities.

- In 1970, the Omnibus Organized Crime Act was passed. LMSA was required to support the efforts of the Organized Crime Strike Force.

- In 1974, the Pension and Welfare Benefit Program (PWBP) was created to administer the Secretary of Labor's responsibilities contained in the ERISA and augmenting the requirements of the Welfare and Pension Plan Disclosure Act of 1958.

- In 1978, responsibility for support to the Organized Crime Strike Force was removed from LMSA and established in the Office of Organized Crime and Racketeering (OOCR) within the Office of Inspector General (OIG).

Currently LMSA operates through a National office, six regional offices and twenty-five area offices. There are independent program administration offices for PWBP and LMSE within LMSA's National office. The area offices operate through two "tracks", separating staff assigned to the enforcement of ERISA and LMRDA.

RESOURCE ALLOCATION

The majority of LMSA's responsibilities in terms of total resources at risk are in the area of employee benefit plans. However, resource allocation between the two offices, as illustrated in the following chart, is roughly equivalent with the number of field enforcement staff slightly favoring union enforcement.

LMSE/PWBP COMPARISONS

	LMSE	PWBP
	Resources	
BUDGET*	22 Million	29 Million
STAFF CEILING*	460	501
FIELD STAFF*	328	278
ENHANCEMENT**	90	23
	Coverage	
ASSETS	6 Billion	550 Billion***
ENTITIES	51,000 Unions	751,000 Plans***
MEMBERSHIP	22 Million	29 Million***
	Impact	
TRENDS	Decreasing Number of Unions and Membership	Increasing Number of Plans and Membership
	No Change in Assets	Assets Increasing 13% Per Year
FEDERAL FINANCIAL LIABILITY	None	Substantial Contingent Liability for Plan Assets (Estimated $400 Million Deficit in FY 1983 for PBGC)

* FY 1984 Budget
** FY 1983 and 1984 Budget
*** Information from ERISA data base, 1981 plan filers

ENFORCEMENT STRATEGY

Historically, LMSA emphasized enforcement of the non-criminal provisions of LMRDA and ERISA. In 1978 a GAO report (HRD 78-154--Laws Protecting Union Members and Their Pension and Welfare Benefits Should Be Better Enforced) criticized LMSA and suggested a stronger enforcement effort for both LMSE and PWBP with a greater emphasis on the criminal provisions of their respective acts.

LMSE, prior to 1978, concentrated on providing technical assistance on provisions of the LMRDA, handling election complaints, reviewing reports for compliance with LMRDA disclosure requirements, and reacting to allegations of criminal activity. After 1978 the Agency shifted to a "proactive" role, emphasizing the detection of criminal activity through the use of on-site audits. With this change in emphasis, a decreasing amount of resources has been directed to union election problems, reporting and disclosure issues, and other functions.

The following illustrates the change in the use of LMSE field staff resources.

Percentage of LMSE Field Staff Time
Devoted to Enforcement Activities

	1978	1979	1980	1981	1982	1983
Audits	1	3	6	19	14	23
Investigations	22	39	35	34	39	32
Subtotal - Audits and Investigations	23	42	41	53	53	55
All Other Enforcement Functions	77	58	59	47	47	45
Total	100	100	100	100	100	100

Source: LMSE FARS Reports

Current plans are to increase the amount of time devoted to audits and investigations to 69 percent in FY 1985, and 73 percent in FY 1986.

PWBP also changed its enforcement strategy, but not as dramatically as did LMSE. The PWBP Compliance Strategy Document was revised in March 1983 in part to rescind past policy restricting criminal investigations. Although PWBP has devoted more resources to investigating the six types of criminal acts for which ERISA provided specific sanctions, including fraud and embezzlement, the majority of staff continue to be involved in the investigation of prohibited transactions by fiduciaries and the associated civil remedies.

OBJECTIVES, SCOPE AND METHODOLOGY

The objectives of our survey were to identify and evaluate specific problem areas within LMSA where formal audit work would be of benefit to management. Because of the reorganization of LMSA called for by Secretary's Order 1-84, further audit work in these areas has been suspended. A preliminary assessment of these problem areas is being provided to the Executive Steering Group and the Enforcement Working Group to assist them in addressing these areas during the reorganization process.

OIG staff have conducted interviews with key managers of LMSA National office components. In addition reports and records were reviewed in LMSA's National office. A limited review was conducted at selected LMSA area offices. This review involved interviews with Area Administrators and Track Supervisors, and an examination of the records of the offices' enforcement activities.

Eight of the twenty-five offices were visited during the survey phase of the review: Atlanta, Boston, New Orleans, Chicago, Cleveland, Los Angeles, St. Louis, and Washington D.C. Four other offices were reviewed during the issue identification process: New York, Seattle, Philadelphia and Kansas City. Those selected included offices which we believe are representative of LMSA's field operations.

The survey was conducted in conformance with "Standards for Audit of Governmental Organizations, Programs, Activities and Functions", issued by the Comptroller General of the United States.

FINDINGS, CONCLUSIONS, AND RECOMMENDATIONS

As discussed in the background section of this report, LMSA has devoted increasing amounts of staff resources to detecting civil and criminal violations of the LMRDA and ERISA. The Fiscal Year 1985 budget calls for substantial increases in audits and investigations.

Concurrent with this increase in emphasis on uncovering criminal activity is a decrease in attention on reporting and disclosure issues. However, the enforcement strategy was developed without adequately defining the need for such an effort or clearly defining the strategy. It has led to ineffective compliance programs and an inadequate enforcement of the reporting and disclosure mandates of both the LMRDA and the ERISA.

LMSE HAS DEVELOPED ENFORCEMENT STRATEGIES WITHOUT EVALUATING ENFORCEMENT NEEDS AND THESE STRATEGIES ARE INEFFECTIVE

The enforcement program operated by LMSE is intended to resolve union election complaints, uncover serious violations of the Act, investigate suspected criminal activity, and administer reporting and disclosure mandates. Our survey of LMSE's enforcement program disclosed serious problems in two of LMSE's major enforcement responsibilities. Specifically, the Compliance Audit Program (CAP) was developed and expanded without evaluating its need and the program has proven ineffective. Also, the Agency has not adequately enforced LMRDA reporting and disclosure mandates.

Compliance Audit Program Was Developed without Evaluating the Need for the Program.

The 1978 GAO report, which was a major factor underlying LMSE's shift in enforcement strategy, criticized LMSE enforcement efforts. The report recommended LMSE increase staff and the number of high quality audits conducted.

To determine staff resources necessary for LMRDA enforcement and identify unions for review, GAO concluded LMSE should:

> "...develop data on the level of compliance being obtained for both laws through its voluntary compliance activities. This would enable LMSA to determine its additional enforcement needs and its future staff and resource requirements."

GAO also concluded that:

> "...In making its selection, LMSA could (1) use data available at the national office, such as volume of annual receipts, prior audit findings, and date of last audit, and (2) apply scientific sampling methods to randomly select labor organizations and benefits plans for field audits."

We believe the GAO conclusions quoted above are necessary for structuring a successful enforcement program. Development of an enforcement strategy requires knowledge of the quantity and nature of violations which the strategy is to address. As GAO recommended, LMSE changed its enforcement strategy, increased staff and increased the number of union audits it conducted. However, LMSE did not determine if a need for this type of enforcement activity existed.

The program developed by LMSE to meet GAO's concerns was the Compliance Audit Program (CAP). CAP is a targeted, structured quick audit of local unions.

Since the inception of the program in 1980, the number of CAP audits has increased. Nine hundred and seventy-five audits were conducted in FY 1983. According to the budget submittals, CAP audits will more than double by FY 1985. The increase is occurring even though there has been no validation of the need for or the effectiveness of the program.

The CAP program was implemented without being adequately evaluated. A limited test program was conducted and the CAP was considered a success. The test, however, was not conducted on a representative sample of unions and the results were biased. The test was conducted in two regions where the Area Administrators were allowed to apply CAP audit procedures to unions of their choice. Some Area Administrators have indicated to us they selected unions for which they had other information suggesting that criminal activity had occurred. Further, the test defined success by the number of embezzlement investigations opened, not violations that were found. These investigations have, however, rarely led to indictments or convictions.

CAP Is Not An Effective Detection Program

The objectives of CAP, in priority order are:

- To uncover Section 501(c) violations (embezzlements) and other criminal and civil violations of the Labor-Management Reporting and Disclosure Act.
- To create a visible enforcement presence in the labor community.
- To provide effective grass roots technical assistance directly to union officials.

CAP has not achieved its objectives. It has not been successful in uncovering criminal activity, resolving many civil violations, nor meeting its enforcement presence or technical assistance goals.

CAP Has Uncovered Few Criminal Violations. LMSE has established the detection of fraud and embezzlements as the primary goal of the program. It is described in the CAP Handbook as "... a hard-hitting audit/investigative approach to *detect* LMRDA criminal and civil violations in targeted labor organizations in a minimum amount of time by using simplified auditing, investigating and reporting techniques" (emphasis added).

Although 2701 CAP audits were completed through FY 1983, data developed by LMSE (shown in the following table) indicate that only 25 convictions have resulted; a success rate of less than one percent.

RESULTS OF CAP

	FY 1980	FY 1981	FY 1982	FY 1983	TOTAL	
CAPs Completed	82	904	740	975	2701	(100%)
Embezzlement Cases Opened	14	93	65	137	309	(11%)
Embezzlement *Not* Found	7	41	23	17	88	(3%)
Still Pending	0	21	24	98	143	(5%)
US Attorney Declined	2	24	11	17	54	(2%)
Convictions	5	7	8*	5	25	(1%)

*8 Individuals convicted in 7 cases

A further analysis of the 25 cases currently identified by LMSE as CAP successes indicates that even these success rates are inflated. In twenty successful CAP cases (those which led to convictions) reviewed at eight area offices indicated seven, or 35 percent, attributed to the CAP program were cases for which the Agency had substantial information that an embezzlement occurred before the CAP case was opened. The primary sources of this information were self-disclosure by unions on their annual financial reports, tips or complaints from union officials (usually newly elected officers who discovered shortages when they were installed in office), losses reported by bonding companies, or losses identified through union conducted audits.

LMSE officials had advised us that in cases such as these, where substantial information of fraud is available, an embezzlement case should have been opened and the incident should not have been reported as a CAP referral. These misclassified cases account for more than one third of CAP's reported success.

CAP Has Not Resulted in Correction of a Substantial Number of Civil Violations. CAP is credited with uncovering many civil violations of LMRDA. Most CAP cases yield findings other than criminal violations. However, in most instances, there is either no documentation to show that LMSE has taken action to resolve the problems identified or the files indicate follow-up would not be pursued. One hundred and fifteen CAP cases we reviewed had civil findings, resulting in 263 individual issues. Violations involved were either reporting and disclosure problems (86 percent) or inadequate bonding (14 percent). In 75 percent of the cases (197) we reviewed, there was either no evidence of LMSE follow-up to assure the bonding or reporting problems were corrected or there was documentation in the file indicating no action would be taken.

CAP May Not Be An Effective Deterrent or Technical Assistance Program. Another objective of the CAP is the deterrent effect of an audit presence. It is difficult to measure the CAPs effectiveness as a deterrent. However, several of the field office managers believe the CAP has reduced the Agency's ability to both deter and detect criminal activity. They commented that, in the past, when LMSE concentrated on reporting problems and technical assistance, the Agency spent more time working directly with union officials and was more visible in the union community. Providing technical assistance to a union took less time than is required by a CAP review; therefore, more unions were visited. Past procedures, according to several LMSE officials, had a greater deterrent effect and resulted in more leads than does CAP. In addition, according to these officials, pre-CAP enforcement efforts assured that reporting problems were identified and resolved.

LMSE Is Not Enforcing LMRDA's Reporting and Disclosure Mandates

During debates which led to passage of the LMRDA, Congress considered several means of enforcing the Act's provisions. A decision was made to minimize federal interference in the internal administration of unions, and to heavily rely upon reporting and disclosure to correct abuses.

For example, the Senate Labor Committee's report on the Bill states:

> "The ultimate responsibility rests upon individual union members to insure that their unions are

> efficiently and honestly run by taking a more active interest in the affairs of their organizations. Voluntary effort will be speeded and strengthened by the provisions of the committee bill requiring full financial reports and public disclosures."

The House Labor Committee also placed reliance on reporting and disclosure to correct abuses. Its report states:

> "It is the purpose of this Bill to insure that full information concerning the financial and internal administrative practices and procedures of labor organizations shall be, in the first instance available to the members of such organizations. In addition, this information is to be made available to the government, and through the Secretary of Labor, is to be open to inspection by the general public. By such disclosure, and by relying on voluntary action by members of labor organizations, it is hoped that a deterrent to abuses will be established."

As discussed above, the added staff directed to the CAP has not produced satisfactory results. In its strategy change, the Agency has also increased the reporting and disclosure problems it faces. Specifically, LMSE has not adequately followed up on unions delinquent in filing reports, and does not possess an adequate program to obtain corrected information from unions which file inaccurate reports.

Many Required Union Reports are Delinquent. In FY 1982, the universe of active labor organizations was 51,430. Key LMSE staff agree there is a significant delinquency problem. However, throughout the years, a declining amount of attention has been devoted to the problem.

Unions are required by the LMRDA to file annual financial reports with LMSE on LM-2 or LM-3 report forms. Filing is required 90 days after the end of the unions' fiscal year.

Approximately 30,000 (60 percent) reports are delinquent each year, and about 10,000 (20 percent) are at least three months late or not received. As of March 1983, over 7300 unions were either one year delinquent in filing a FY 1982 report, or had not filed reports for two or more successive years.

In the past, responsibility for obtaining delinquent reports was delegated to the area offices. This responsibility was transferred to the National office in June 1980. The transfer was made because it was believed: 1) the National office could do the work more efficiently, and 2) pursuing delinquent reports was diverting area office staff from their primary responsibility of investigating embezzlements. The National office had initially proposed using six full-time staff in this effort. The actual staff time never reached that level.

LMSE's failure to devote adequate staff to the problem is compounded by untimely and ineffective delinquency notification and follow-up procedures. The process used by LMSE to handle delinquent reports in 1983 was as follows:

1. A computer generated delinquency notice was to be sent to delinquent labor organizations 15 days after the report due date. However, because the large number of delinquent filings at the beginning of each calendar year (10-15,000) created a large workload, notices were not sent until July or August.

2. At the time the delinquency notice was printed, a card was produced, manually sorted, and forwarded to the appropriate area office. The area office was to use the cards to determine if the union incorrectly filed the report with the area rather than the National office. Area offices were asked to send the copies to the National office. This procedure resulted in few reports being found.

3. A letter was sent to the delinquent labor organization one or two months after the delinquency cards were produced. A follow-up letter was to be sent two or three months later. These time frames were not met.

4. A certified demand letter was to be sent 2 or 3 months after the last delinquency letter. This deadline was seldom met.

5. If the delinquent labor organization did not respond to the demand letter, no further action was taken.

In the past, LMSE had a task force working on problems in the delinquency system. After discussing delinquency problems identified during our survey work with LMSE staff, the task force was reactivated. While changes were made to the system, we do not feel that it has been substantially improved. Currently, neither the demand letters nor the area office delinquency cards are being sent.

In addition to the National office's work in obtaining delinquent reports, field office staff are to identify reporting problems and obtain correct reports as a part of their enforcement efforts, such as the CAP. However, as previously discussed, reporting problems identified in the course of CAP reviews are often not resolved by area office staff. The low priority assigned reporting issues by field staff appears to be the result of LMSE's change in enforcement strategy. However, we were unable to develop comparative data on the effectiveness of the Agency's prior delinquency program and the current program where responsibility was transferred to the National office and staff devoted to the program reduced. Several LMSE managers did tell us that prior to the change the problem was not severe because the staff was able to visit many more unions when they concentrated on reporting issues and technical assistance.

Errors in Union Reports are Not Satisfactorily Corrected. Data provided by unions is often inaccurate. However, LMSE does not have an effective program to obtain corrected information. The information maintained by LMSE contains many errors because LMSE's procedures are inadequate to correct reporting and key entry errors.

Many reporting deficiencies discovered on Labor Organization Annual Reports (LM-2 or LM-3) are not corrected. In FY 1982, the computer generated 18,457 Referral Reports. Referral Reports are computer printouts on unions whose Annual Financial Reports were identified as having problems significant enough to be flagged. Only about 9000 of the Referral Reports were reviewed. The selection of those to be reviewed was not on a priority basis, but on a first-in, first-out system. No further action was taken on those reports not chosen for review. After being advised of this problem, LMSE adjusted "tolerance levels" to decrease the number of reports produced by the computer. The reviewers may now be capable of reviewing all of the reports; however, this doubling of the tolerance levels did not take into account the relative importance of the factors involved. Some reporting deficiencies will now never be flagged by the system and will remain uncorrected.

The computer generated Referral Reports which are selected for review are evaluated manually. The reviewer pulls the appropriate files and compares the Annual Report to the Referral Report to determine if the Referral Report information is valid. In cases where reporting deficiencies are found (3306 in FY 1982), a letter is prepared requesting the labor organization to make the necessary corrections and file an amended report. Due to clerical shortages, many letters were never typed nor mailed; therefore, no corrective action was ever taken.

When keypunch errors were discovered, no action was taken to correct them. When the reviewers discover errors they are to enter the correct information and return the forms to the section responsible for key entry. We discovered the transfer was not taking place and found 1,500 of the forms piled on a desk. Errors on the 1,500 forms could not be corrected because the examiners had not identified specific changes which had to be made. Rather, they had only indicated an error existed. The reports would have to be pulled and re-reviewed to identify specific errors. When advised of the problem LMSE did change its error correction procedures. The examiners are now identifying the specific problem on the forms; however, not all errors are being corrected in the system.

LMSE'S Enforcement Strategy May Be Misdirected

Our review of non-CAP embezzlement cases indicates the majority of LMSE's successful cases result from reporting and disclosure or tips. Proactive reviews (such as the CAP) are yielding limited success. Of the 48 successful embezzlement cases (those which led to convictions) we reviewed:

23%	(11)	were opened based upon information disclosed by the union on required reports.
52%	(25)	were opened based upon tips or complaints received, usually from newly elected union officials who discovered shortages upon taking office.
8%	(4)	resulted from LMSE actions.
4%	(2)	were opened based upon information in newspaper articles.
2%	(1)	was opened based upon the union's failure to file required reports.
11%	(5)	files lacked sufficient information to identify the source.

This suggests that LMSE might be more effective by concentrating its efforts on information provided directly or indirectly to the Agency rather than proactive audits. Obviously, this would entail improving the reporting and disclosure effort to assure current, correct information is available.

Factors other than the limited success of the proactive effort also suggest the problems which the program is attempting to address may not exist in sufficient quantity to justify the strategy.

LMSE is not the only organization interested in assuring that unions are free from criminal activity. The LMRDA was passed in response to disclosures (McClellan Committee hearings of the 1950's) of serious problems in unions. The focus of the Committee's investigations was the racketeering and other serious abuses uncovered, primarily in the Teamster's union. In fact, portions of the Act read as if it were directed solely at the Teamster's union. However, in 1978, OOCR* assumed responsibility for investigating racketeering and organized criminal activity in unions and for providing the Department's liaison role with the Strike Force. Many of the problems which led to the passage of the Law are no longer within LMSE's responsibilities. LMSE has never demonstrated that the non-organized crime and racketeering in unions is serious enough to justify a substantial federal audit program.

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*Office of Organized Crime and Racketeering

Also, although it is not required by the Legislation, many unions have external audits conducted. Our review of 147 CAP cases which led to an embezzlement case indicated that 72 of them had an external audit. Most embezzlements found in these cases were disclosed by the audit. Perhaps the unions' own efforts to uncover and solve problems within their organizations are having an impact on deterring and resolving the problems. LMSE has never analyzed the extent of voluntary compliance with the Law.

CONCLUSIONS

None of the above information conclusively demonstrates LMSA's enforcement strategy is misdirected. However, it does present some questions to be answered before a major enforcement strategy is developed and implemented. The apparent imbalance between enforcement responsibilities and resources of LMSE and PWBP suggests the Agency may not be directing its emphasis to the most serious problems. That LMSE's major enforcement program, CAP, is not yielding satisfactory results suggests either there are problems in the way it is conducted, or the embezzlements it was designed to uncover may not exist in sufficient magnitude to justify the program. The problems in reporting and disclosure when viewed in light of the legislative history suggest a misallocation of resources or priorities.

What the above information does suggest is a need to clearly define the problems which the Agency was created to resolve and to design enforcement programs appropriate for these problems.

PWBP'S MANAGEMENT OF ENFORCEMENT AND REPORTING MANDATES NEEDS IMPROVEMENT

The ERISA attempts to regulate the activities of approximately 751,000 employee benefit plans containing about $550 billion in assets and covering an estimated 29 million participants. Congress, through ERISA, provided two primary means of protecting the interests of employee plan members and their beneficiaries: (1) federal enforcement oversight and (2) public disclosure.

The first means, authority which allows federal review of plans, is shared by PWBP and the Treasury Department's Internal Revenue Service (IRS). The IRS reviews plans for conformity with participation, accrual of benefits, and retirement vesting provisions. The IRS also has authority to determine if a plan is adequately funded so sufficient assets are available to pay participant benefits at retirement. If a plan does not meet the ERISA and Treasury requirements, the plan can be disqualified from tax exempt status, or an excise tax can be levied against the employer.

LMSA's PWBP also has the authority to review plans' financial activities. PWBP has responsibility for assuring plans are properly managed, plan assets prudently invested and the rights of plan participants protected. When a violation is identified, PWBP will attempt to obtain correction either through voluntary compliance or civil litigation. In addition, ERISA identifies certain acts as criminal. Violators can be fined and imprisoned.

The second means is to involve employee benefit plan participants in protecting their own interests. PWBP is responsible for enforcing "sunshine" provisions of the ERISA by assuring participants obtain all plan information to which they are entitled. For this purpose, PWBP is required to maintain a public disclosure facility. In addition, PWBP enforces reporting requirements intended to provide both participants and the federal government with accurate, timely and complete plan information.

The goals of the ERISA enforcement, and reporting and disclosure requirements are related. The effectiveness of each is dependent on how well the other is managed. Both federal enforcement and public involvement rely on obtaining information with which violations can be identified.

The following sections of this report discuss problems with PWBP's enforcement, and ability to obtain accurate data for its own enforcement needs and public disclosure responsibilities. Discussed are weaknesses in PWBP's:

- enforcement strategy,
- targeting methods, and
- management of its public disclosure and enforcement information needs.

PWBP Has Not Clearly Defined Its Enforcement Strategy

Good has come from PWBP's efforts to protect employee benefit plan members and plan assets. For the fiscal year ended September 30, 1983, PWBP reported closing 233 cases in which $13.6 million in assets were restored to employee benefit plans. An additional $38.2 million in financial transactions prohibited by ERISA were identified and reversed.

PWBP also reported closing 570 additional cases in which nonmonetary ERISA violations were identified. However, as a result of our survey of enforcement policies and procedures, we concluded PWBP has not done an adequate job of defining its enforcement strategy or the best methods of identifying violators.

In January 1978, the first paper was issued by PWBP (called a Compliance Strategy Document) defining its enforcement policy and procedures. It emphasized enforcement of ERISA fiduciary provisions "to secure assets and to recover losses". It directed PWBP field staff to minimize criminal investigations and time spent on other ERISA civil provisions such as reporting and bonding violations and technical assistance. The policy was enforced by requiring field staff devote a minimum 85 percent of their time enforcing the ERISA fiduciary provisions. Guidance on the types of plans to audit was limited to a discussion of the importance of developing "significant cases". Significant cases were defined as:

> "...cases with high litigation potential, cases in which substantial assets or numbers of participants are involved or cases in which individuals, companies or unions are involved in or identified with past violations of this or other laws."

A report on the ERISA enforcement, issued by a joint OIG-LMSA task force in May 1982 found general dissatisfaction with the Compliance Strategy Document among National and field staff. PWBP staff complained that the policy was "vague, ambiguous and incomplete". Staff commented that the significant case process and time constraints resulted in too many unproductive reviews of large plans and inadequate attention to other ERISA violations.

In response to the review, the strategy document was replaced by another in March 1983. PWBP's strategy, as identified in the current document is:

> "to provide a balanced enforcement program; a program where major attention is given to cases including fiduciary duties and prohibited transactions, but where reporting violations, bonding violations, prohibitions against criminals serving as fiduciaries, and matters such as theft or embezzlement from plans, and other criminal violations are pursued."

The document rescinded restrictions on working criminal cases. It also decentralized enforcement authority and eliminated the requirement for the significant case process.

While the revised document called for increased enforcement of other provisions of the ERISA it retained a requirement that 85 percent of available field enforcement time be devoted to identifying and examining plans for fiduciary and criminal violations. Further, it provided little specific direction on enforcement responsibilities.

Lacking specific direction, PWBP field offices have developed their own enforcement policies and targeting procedures. As a result, enforcement priorities and procedures are fragmented among PWBP's 25 area offices, with no assurance that methods being used are effective.

Enforcement Targeting Methods are Inconsistent and Poorly Evaluated

PWBP's National office has conducted several major computer assisted targeting projects since inception of the ERISA. All involved analysis of financial data supplied on Annual Reports filed with the IRS and other data available to PWBP.

None of the past projects has gathered information necessary to evaluate the results. Field offices were not required to open cases based upon National office targeting referrals or report the success of criteria on those which were selected. Referrals were provided area offices on a "take-it-or-leave-it-basis".

The most recent computer assisted analysis, dubbed "Short Term Targeting" (STT), was the first project in which information necessary to attempt evaluation was gathered. The project, begun in FY 1983, was originally envisioned as consisting of 10 separate programs; only three of which have been implemented. Field offices were instructed to open all cases referred to them unless the plan involved had been reviewed in the past year. Evaluation forms to be completed by field managers accompanied the referrals.

Although PWBP considered the project a success and recommended other projects based upon the results, it contained several design flaws which prevented proper evaluation. Inadequate follow-up on responses was completed. Of the 466 cases referred to field offices, evaluation forms on 278, or 60 percent, have not been returned. Because of poor initial screening, 47 percent of cases, in which an evaluation form was returned, indicated the area offices rejected the referral because the plan had been reviewed in the past year.

In addition, the criteria for success was any referral in which a review had been completed in the past year or in which the field offices, as a result of a referral, began a compliance review; not the effectiveness of programs in detecting violations.

The result has been duplication of effort and recommendations for audits in areas in which past enforcement efforts had been extensive. As discussed in a report prepared by PWBP staff on the STT project:

> "Despite the obviously successful test results, this program has limited value for future targeting purposes. It is evident from the number of prior cases that the field has been employing their own questionable investments targeting techniques for some time. There are not many viable questionable investment targets remaining. This entire area has received a great deal of attention since inception of the ERISA and many of the larger plans are aware of the party-in-interest and prohibited transaction pitfalls."

In addition to National office projects, field offices also employ their own targeting methods. National office targeting referrals are not the primary source used by field offices in opening cases. Among the eight field offices we visited, only two viewed National office products as a primary source of information in selecting plans for review. Most of the field offices we visited believed National office targeting was ineffective, and relied on their own targeting methods or other sources for selection.

Lack of faith in National office targeting referrals is illustrated by the types of targeting activity which has occurred. During the period 1980 through 1983, while the National office was providing the field offices with targeting referrals under a variety of programs, the field offices requested and received from the National office 66 special analyses of information to be used for their own targeting efforts.

Field offices use a variety of methods and procedures for selecting plans for review and spend substantial time in selecting plans to audit. Our review of enforcement time sheet summaries shows some offices spent over 20 percent of available field time during FY 1983 on targeting.

Methods range from sophisticated analysis of plan financial and industry data to audits initiated as the result of tips. Field offices conduct "in-house targeting" which involves desk reviews of Annual Reports and other data, and on site targeting in which the auditor or investigator reviews plan records and attempts to detect violations. In some offices it is the responsibility of each investigator or auditor to determine plans to review. In others, selection is made by the supervisor.

We found no consensus among regional offices as to the best methods of targeting plans for review or the best sources of information. Procedures vary among area offices and individual staff within an office. Only two of eight area offices visited indicated an awareness of procedures being used in other offices.

There is also wide disparity among offices in the success of their selection methods. Nationally, FY 1983 statistics indicate no violations were found in 64 percent of area office cases closed. The percentage of unsuccessful cases among area offices ranged from a high of 93 to a low of 35 percent.

Common among all offices, however, was failure to evaluate the effectiveness of projects and methods. Only two of the eight offices we visited had done any analysis of past projects. There was a tendency, as with past National office efforts, to identify targets, complete the reviews and start another project.

Management of Disclosure and Enforcement Information Needs is Inadequate

The ERISA establishes complex reporting and disclosure requirements. Plan administrators must provide participants with information on plan provisions and financial activity. Administrators, depending on the size and type of plan, must also file "Annual Reports" (IRS Form 5500 series) with the IRS and other special reports with PWBP. The reports contain detailed information on plan financial activities. Further, any employee benefit plan which has over 100 participants must arrange an annual audit by an independent public accountant.

Under a current DOL/Treasury agreement, IRS assumes responsibility for Annual Report deficiencies and delinquencies; PWBP maintains responsibility for deficiencies and delinquencies on other required reports. In addition, the ERISA charges PWBP with the responsibility of maintaining a public disclosure facility where any interested party can obtain copies of reports filed by plan administrators.

The success of both participants' understanding and involvement and PWBP's enforcement efforts depend in large part on obtaining current, accurate, understandable data. PWBP relies on information obtained from benefit plan reports to fulfill its public reporting and disclosure responsibilities and for enforcement and research statistics. However, neither plan participants nor PWBP's information needs are being adequately met:

- Information provided plan participants by plan administrators is not understandable and does not accurately describe to participants their rights and obligations.
- Information used by PWBP for public disclosure and enforcement is not complete, accurate or timely.
- Information which assists PWBP in its enforcement efforts is not being monitored or properly used.

Information Provided Plan Participants is Inaccurate and not Understandable. To resolve communication problems, ERISA legislated requirements that simplified explanations of employee benefit rights, and obligations be provided by the plan to each plan participant and beneficiary.

The abbreviated documents, called Summary Plan Descriptions (SPDs), are to be written in a manner "understandable by the average plan participant and be sufficiently accurate and comprehensive to apprise participants of their rights and obligations".

SPDs do not fulfill their intended purposes. A study of SPDs was conducted by PWBP's Office of Reports and Disclosure (ORD) in 1979. ORD reviewed a random sample of 1000 SPDs involving plans with over 100 participants to determine if they were in compliance with the law and regulations. Reviewed were their content, readability and accuracy. Using linguistic analysis, the study found that a reading level of 14.6 years (2.6 years beyond that of a high school graduate) was needed to comprehend the average SPD. Also tested was how well the SPD agreed with information in the Plan Description. In several areas designated as critical the SPDs were inaccurate on 35 percent of the items.

Also at issue are the administrative expenses borne by the plans in preparing, printing and distributing SPDs to plan participants to comply with the ERISA requirement, and PWBP facilities and staff time devoted to maintaining a public disclosure facility. Approximately 100,000 SPDs are submitted annually to PWBP. Unless they fulfill their intended purpose much time and expense is wasted.

Public Disclosure and Enforcement Information Needs are not Being Met. Problems experienced by PWBP in providing information to the public also hamper PWBP's ability to make effective use of information for enforcement and statistical purposes.

PWBP also experiences problems in meeting its public disclosure responsibilities and enforcement needs. Under a DOL/Treasury agreement, PWBP relies on the IRS to obtain Annual Reports filed by benefit plan administrators. The reporting arrangement has historically been the subject of controversy and conflict and created problems for PWBP in providing accurate, timely information to the public.

PWBP has complained that in the past, the IRS did not pursue delinquent filers or assure information on the Annual Reports was accurate or complete. PWBP has also complained it receives Annual Report data long after it has been filed.

Although information was not available to assess the seriousness of the delinquency problem, the most complete statistics we could obtain from the IRS, based on 1981 plan year filings, indicate about 124,000 Annual Reports filed with the IRS were delinquent.

No data could be obtained on the number of Annual Reports filed with reporting deficiencies, from either PWBP or the IRS. However, past PWBP experience suggests deficiencies are common. During Fiscal Years 1978 through 1981, ORD conducted a project to review Annual Reports for deficiencies. The reports were checked for missing items, incorrect addition, inconsistency between related items, and missing or incomplete schedules and attachments. Deficient reports were referred to PWBP's Office of Enforcement to be pursued. The project was discontinued (no statistics were kept) because the workload became too heavy.

The reporting arrangement has contributed to delays in receiving Annual Reports. In FY 1983, PWBP paid a contractor $1.2 million to make microfiche copies of Annual Reports received from the IRS. The microfiche is used by PWBP to make "hard copies" for public disclosure requests. The contractor must wait from six to nine months, until the IRS Service Centers complete processing and data entry, before being allowed access to the Annual Reports. After processing, additional time is needed to prepare the microfiche, and for PWBP to index and file the reports so they may be retrieved. Hence, long delays are encountered in providing current data to the public.

Annual Reports are a primary information source used by field offices for enforcement. PWBP's National office sends microfiche copies of Annual Reports to its area offices. Managers in all eight area offices we visited commented that the age of the microfiche limits its effectiveness. The most current microfiche we found in any office visited was for the 1981 plan year. Some managers commented that the microfiche was useless and they no longer request copies. Instead some visit IRS Service Centers to review and obtain more current data. Although PWBP reports that the time lag in receiving Annual Reports is being reduced, this may not resolve field information needs. Only two area office managers indicated they would use the microfiche if it were more current.

IRS has recently instituted civil penalties for deficient Annual Reports as the result of a critical 1981 General Accounting Office report. Civil penalties of $25 a day to a maximum of $15,000 can be levied for reports and schedules omitted or for items on Annual Reports designated as "critical", which are missing.

The effectiveness of penalties in improving the timeliness and completeness of reports submitted by plan administrators cannot now be determined. More time must pass before the impact can be measured. However, the new procedures will not resolve problems related to timely receipt of information by either the public or PWBP field offices.

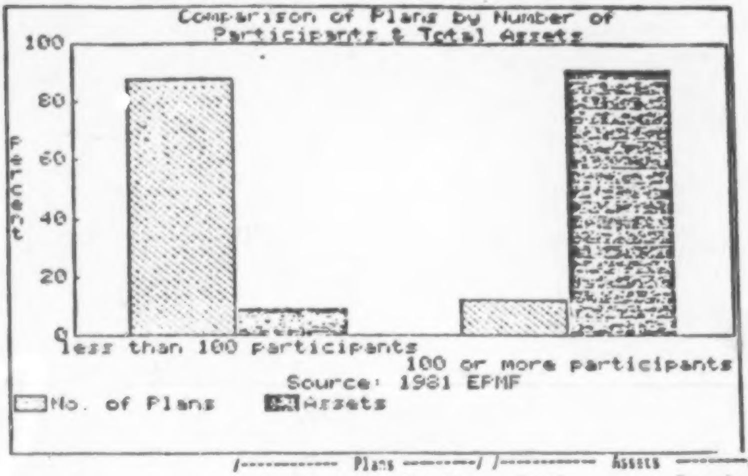
Disclosure Requirements Which Augment Enforcement Efforts are not Being Monitored. In the past, PWBP has not had procedures to assure independent audits of employee benefit plans, required by the ERISA, were being completed. We believe closer monitoring of external audits could improve PWBP's enforcement efforts.

There are a huge number of employee benefit plans and a limited number of PWBP enforcement staff. Our analysis of 1981 Annual Report filers (the most current information available to us) indicated over 751,000 Annual Reports were submitted. All predictions are that the number of plans will continue to increase. In FY 1983, PWBP with a field staff of about 261 was able to accomplish about 2200 reviews.

A means of augmenting PWBP's enforcement resources is provided in the legislation. Part I, Section 103 of the Act requires plans with over 100 participants obtain an annual audit by an independent public accountant (IPA). An opinion on the financial reports and an actuarial statement are required.

The ERISA also requires the IPA report contain information relating to compliance mandates of the ERISA. They include disclosure of material commitments, contingent liabilities, priorities upon termination of the plan and transactions with parties-in-interest. The IPA report is required to be attached to the Annual Report.

Adequate IPA review is paramount. As illustrated in the following table, a relatively small number of plans, subject to the ERISA audit provision, contain the majority of plan assets:



Source: 1981 EPMF

Size of Plans	Plans Number (in thousands)	Plans Percentage to Total	Assets Amount (in Billions)	Assets Percentage to total
100 or more participants	88	12%	$503	91%
less than 100 participants	663	88%	$47	9%
Totals	751	100%	$550	100%

The number of plans shown above which receive annual audits is probably understated. Some smaller plans probably secure annual audits as a matter of course.

In the past, PWBP has had no procedure to assure required IPA audits were being completed. Recently, we were told PWBP's National office has developed procedures (soon to be implemented) to identify and contact plans subject to the requirement which have not obtained an audit. PWBP intends to seek voluntary compliance.

While improving compliance with requirements may assist plan administrators in policing their own activities, a means of tying IPA efforts to PWBP's enforcement needs has yet to be established.

To be effective, a reporting arrangement must be developed which alerts PWBP of ERISA violations and potential fraud without requiring inordinate PWBP staff review.

Currently, IPA's are not obligated to notify PWBP of ERISA violations or even instances of fraud involving plan assets. The IPA's client is the plan administrator or board of directors. As a result, although the information may be disclosed in the IPA's report, lack of PWBP resources to review the report may result in problems going unnoticed. To establish a client relationship between PWBP and the IPAs, statutory changes to the ERISA may be necessary.

CONCLUSIONS

Organizationally, PWBP has not provided its staff a well defined enforcement strategy. Past enforcement policies have emphasized the need to enforce the ERISA fiduciary provisions. However, they have not contained specific guidance necessary to identify enforcement priorities or direct enforcement efforts. Both National and field staff have embarked on numerous case targeting methods characterized by much experimentation and little effective analysis of results. As a result, information necessary to identify priorities and successful case targeting methods is dispersed throughout the organization.

Problems with enforcement guidance and evaluation are compounded by PWBP's difficulty in obtaining accurate, timely information necessary for both public disclosure and its own enforcement needs. Although new penalty systems have been instituted recently by the IRS which may reduce past problems with delinquent and deficient filings, methods of providing timely information to PWBP's enforcement staff and to the public remain to be established.

Even with substantial increases in staff, PWBP could not adequately enforce the ERISA relying only on its own resources. PWBP must establish means of augmenting its efforts. More effective reporting relationships with public accountants and better use of their work could increase PWBP's effectiveness.

LMSA STAFF RESOURCES COULD BE USED MORE EFFICIENTLY

Our survey of LMSA did not focus on organizational structure. However, reorganization does provide an opportunity to re-evaluate staffing levels and staffing patterns. Therefore, we are providing to the Executive Steering Committee areas where we feel staffing levels and patterns should be re-evaluated.

We found:

- PWBP's National office contains unnecessary duplicative functions.
- Excessive levels of enforcement review exist in LMSE.
- LMSA should re-evaluate its field office structure.

PWBP's National Office Contains Duplicative Functions

PWBP's National office organizational structure encourages unnecessary specialization of functions, overlapping of responsibilities among offices and ineffective use of staff resources.

Both PWBP's Office of Fiduciary Standards (OFS) and Office of Reporting and Plan Standards (ORPS) are involved in drafting regulations, interpreting the provisions of ERISA and granting exemptions and variances under the Act. OFS' principal function concerns the ERISA fiduciary provisions while ORPS deals primarily with reporting and disclosure requirements. Although the offices deal with separate provisions of the ERISA, their functions are similar.

The two offices were created at a time when plans were filing their initial reports with LMSA and regulations had not been issued. At the present time the majority of plans have met their initial filing requirements and most reporting regulations have been issued. Therefore, ORPS' workload requirements have diminished and the need to staff separate offices no longer exists.

We also noted that some of the staff assigned to the Office of Reports and Disclosure (ORD) are underutilized. For example, because of clerical shortages, ORD examiners who were trained in accounting skills to perform preaudit examinations of Form 5500s are now being used in the file room. This office was originally staffed at the inception of ERISA in anticipation of the large volume of reports to be filed by plans. As with ORPS, workload has diminished and PWBP priorities have changed.

A review conducted by an OASAM/LMSA Task Force in July 1983, identified similar problems involving PWBP's organizational structure. Our survey led us to concur with the findings of the OASAM/LMSA Task Force.

Excessive Levels of Review Exist

LMSE has many levels of casework review. They are often duplicative, too late to be of value, and ineffective.

LMSE investigators' work is reviewed as many as five times before reaching the National office. Work is first reviewed by the Track Supervisor, in some offices by the Deputy Area Administrator, then by the Area Administrator, the Assistant Regional Administrator (ARA), and possibly by the Regional Administrator. Once received by the National office, cases are reviewed by the responsible branch in LMSE, and also by the Office for Field Operations during its onsite visits.

All CAP cases, regardless of results, are reviewed by LMSE. This is done even though few CAP cases contain findings of significance. LMSE National office managers commented that 100 percent review is conducted to assure the quality of field office casework. However, in FY 1982 less than one half of one percent were returned for correction.

All election cases are reviewed by the National office. Election complaints, according to law, must be acted upon within 60 days. LMSE allows the field office 30 days to complete an investigation and to forward the case to the National office. The case is sent to the ARA for review at the same time it is sent to the National office. LMSE National office staff indicate the ARAs, in about 40 percent of the cases, do not conduct a review within the time constraints. Further, in about 30 percent of the cases, findings resulting from National office reviews differ from those of the field offices. However, in order to meet deadlines, the cases are not returned to the area offices.

The National office plan is to review a 25 percent sample of closed embezzlement cases. In embezzlement cases, the field offices work directly with the U.S. Attorneys' (USA) offices. The National office review is completed after the USA has decided what action will be taken on a case; therefore, the review does not improve its prosecution merit. Further, few cases are returned to the field as a result of embezzlement case reviews.

Excessive layers of staff apparently result in equally excessive levels of review. Despite all of the reviews, little feedback goes to the field either on a case by case basis or on systemic problems. Consequently, problems in quality of the casework are not corrected.

Field Office Structure Should Be Re-Evaluated

Several factors suggest a need to review the field office structure of the Agency: (1) the existing field office structure was developed almost 25 years ago for a very different organization than now exists; (2) there are wide variations in workload among the offices; and (3) the two smaller agencies resulting from the reorganization may not require the administrative overhead contained in the existing structure.

The existing field office structure was established for LMSE in 1960, and has continued with only minor modifications since that time. When ERISA was passed, the PWBP staff were placed in the office locations which had been established for LMSE. However, since that time, there have been significant changes affecting the organization.

LMSA assumed responsibility for the ERISA in 1974, and has since lost several functions; most notably the organized crime program which was moved from LMSA to the OIG. Management of the Veterans Reemployment Program was moved under the Assistant Secretary for Veterans' Employment and Training. And now, PWBP is being established as a separate organization. The organization has, at various times, centralized and decentralized. Staffing levels have changed over the years. Yet the field structure has remained intact, with only minor modifications.

Both LMSE and PWBP have assigned staff to the existing offices on the basis of the number of unions or employee benefit plans within the office's jurisdiction. However, the criteria used has not proven an indicator of workload. Workload and productivity vary greatly from office to office. For example, according to LMSE's analysis of field office statistics for the period October 1, 1978 through March 31, 1982, the number of cases worked per investigator varied from about five cases in Los Angeles and New York to almost twenty in Cleveland. The number of cases prosecuted per investigator ranged from about 0.3 in Los Angeles, San Francisco, Miami and New York to 2.3 in Detroit, almost eight times the effort.

Likewise, PWBP workload varies greatly among its offices. For example, the number of cases closed per non-supervisory staff during Fiscal Year 1983, ranged from less than three in Chicago and Washington to over thirty in Los Angeles and Denver.

We are not suggesting that the workload measures we have discussed above are methods by which staff resources should be assigned. There are valid reasons for variations among offices. For example, an area office may be involved in a very large embezzlement case using a large amount of the office's resources for a substantial period of time. As a result, the number of cases prosecuted per investigator might be low. However, we are suggesting LMSA evaluate its field structure and develop meaningful measures with which to assign staff resources.

LMSA has a substantial number of management and support staff for field office functions. In addition to the National office's Office for Field Operations, the Agency also has six Regional offices. Each of which has a Regional Administrator (SES), an Assistant Regional Administrator for each of the two tracks (GM-14), and other management and support staff.

The area offices have Area Administrators (GM-15), some Deputy Area Administrators (GM-14), at least two track supervisors (GM-13), and clerical support staff.

The 1982 OIG/LMSA report criticized the high ratio of field management/supervisory staff to investigator staff. A 1977 study of field office structure, commissioned by LMSA also recommended changes to field supervision/investigator ratios.

According to a December 1983 LMSA staffing report, actual field staff levels were:

Regional Offices	
Regional Administrators (SES)	6
Assistant Regional Administrators (GM-14)	13
Deputy Assistant Regional Administrators (GM-13)	6
Total Management	25
Clerical	22
Area Offices	
Area Administrators (GM-15)	23
Deputy Area Administrators (GM-14)	4
Track Supervisors (GM-13)	57
Total Management/Supervisory	84
Auditors/Investigators	370
Clerical	97

The ratios of auditors/investigators to management/supervisory and support staff are:

Track Supervisor/Professional ratio -- 57/370 = 1 to 6.5.

Field Staff Management and Supervision/Professional ratio -- 109/370 = 1 to 3.4.

Total Field Staff Management and Support/Professional ratio -- 206/370 = 1 to 1.8.

Once the responsibilities of PWBP and LMSE are separated, we believe the staffing and grade structure will be unsupportable.

A review of field office locations should be accomplished as a part of the reorganization process, with the goal of evaluating the staffing and workload of the offices. Staff should be reassigned as necessary.

RECOMMENDATIONS

We recommend that the Executive Steering Group and the Enforcement Working Group evaluate the enforcement strategies of both LMSE and PWBP with the goal of determining how Agency staff could be best used. Adequate analysis requires these Groups to:

- Determine the LMRDA and the ERISA violations which are occurring, the frequency with which they occur, and the potential loss they represent. Random selection of unions and pension plans, coupled with thorough review and statistically valid projections, would provide a basis to identify the magnitude and importance of violations which occur.
- Establish priorities between the statutory responsibilities of LMSE and PWBP. Consider the responsibilities of both organizations and the amount of risk assumed by union members, plan participants and the public, and decide what enforcement efforts warrant LMSA's resources.
- Establish priorities within the provisions of each statute. Select from among the enforcement, reporting, disclosure and other mandates of each Act those provisions whose enforcement would provide optimal protection of public assets.
- Identify the most effective enforcement procedures to uncover and correct violations. Develop adequate means to identify violations and to assure they are corrected. The design of procedures should consider the uses which can be made of the efforts of other government and non-government organizations.
- Develop a management structure which supports the established enforcement priorities and provides field enforcement staff with adequate information, technical support and guidance.
- Determine, based upon the above analyses, where LMSA resources should be assigned. Geographic locations, supervisory needs, and staffing levels should be identified.

We do not suggest that either LMSE or PWBP cease enforcement activities until the evaluation can be accomplished. However, the information we examined indicates that LMSE's most successful cases are the result of tips or other referrals. We are therefore recommending that LMSE limit CAP detection efforts until the evaluation is complete. We further recommend that PWBP avoid conducting further National office targeting projects until the effectiveness of plan selection methods is established.

Raymond J. DONOVAN, Secretary of the United States Department of Labor, Plaintiff-Appellee,

v.

John C. BIERWIRTH, Robert G. Freese and Carl A. Paladino, Defendants-Appellants.

and

Joseph W. Ullman, Lillian E. Baldissard, Rita V. Hafner, Anthony Pancella, Jr., Kathleen T. Chew and Benjamin L. Crews, Intervenors-Appellants.

No. 880, Docket 82–6004.

United States Court of Appeals,
Second Circuit.

Argued March 19, 1982.
Decided May 10, 1982.

Secretary of Labor brought action against trustees of corporate pension plan alleging that trustees had breached their fiduciary duties. The United States District Court for the Eastern District of New York, Jacob Mishler, J., 538 F.Supp. 463, granted the Secretary's motion for preliminary injunction and appointment of receiver pendente lite, and trustees appealed. The Court of Appeals, Friendly, Circuit Judge, held that: (1) trustees breached their fiduciary duty by failing to resign when their positions as trustees came into conflict with their positions as corporate officers and directors during takeover bid and by purchasing stock of corporation with pension fund monies, and (2) appointment of receiver pendente lite was unnecessary where interlocutory relief prohibiting trustees from buying, selling or exercising any powers, rights or other duties regarding corporate stock was issued.

Affirmed as modified.

1. Master and Servant ⚷78.1(7)

Provision in Employee Retirement Income Security Act prohibiting fiduciary from acting in any transaction involving plan on behalf of party whose interests are adverse to interests of plan or interests of participants or beneficiaries requires transaction between plan and party having adverse interest and thus did not apply to trustee's purchase of employer's stock, even though trustees were also officers of employer. Employee Retirement Income Security Act of 1974, § 406(b), (b)(2), 29 U.S.C.A. § 1106(b), (b)(2).

2. Master and Servant ⚷78.1(7)

Although officers of corporation who are trustees of its pension plan do not violate their duties as trustees by taking action which, after careful and impartial investigation, they reasonably conclude best to promote interests of participants and beneficiaries simply because it incidentally benefits corporation or themselves, their decisions must be made with eye single to interests of participants and beneficiaries; this imposes duty on trustees to avoid placing themselves in position where their acts as officers or directors of corporation will prevent their functioning with complete loyalty to participants demanded of them as trustees of pension plan. Employee Retirement Income Security Act of 1974, §§ 404, 404(a)(1)(A, B), 407(a)(3), 408(c)(3), 29 U.S.C.A. §§ 1104, 1104(a)(1)(A, B), 1107(a)(3), 1108(c)(3).

3. Master and Servant ⚷78.1(7)

Corporate officers failed to observe high standard of duty placed upon them as pension plan trustees by continuing as trustees of pension plan even after tender offer for takeover of corporation was made which affected price of all corporate stock including stock held by pension plan and after they decided in their capacity as corporate officers to fight takeover, by failing to ascertain facts with respect to offeror's pension plans or investigating what could be done to protect their pension plan in event of acquisition, and by determining to purchase additional corporate stock from pension fund purportedly for investment when price of stock had been inflated by tender offer. Employee Retirement Income Security Act of 1974, §§ 404, 404(a)(1)(A, B), 407(a)(3), 408(c)(3), 29 U.S.C.A. §§ 1104, 1104(a)(1)(A, B), 1107(a)(3), 1108(c)(3).

4. Receivers ⇐7

Appointment of investment manager to act as receiver pendente lite for pension plan while controversy over pension fund's purchase of stock of employer while tender offer was pending was unnecessary where preliminary injunctive relief was granted prohibiting trustees from buying, selling or exercising any powers, rights or other duties on behalf of the pension plan regarding employer's stock except upon further order of court. Employee Retirement Income Security Act of 1974, §§ 404, 404(a), 406(b), 502(e)(1), 29 U.S.C.A. §§ 1104, 1104(a), 1106(b), 1132(e)(1).

Robert N. Eccles, Atty., U. S. Dept. of Labor, Washington, D. C. (T. Timothy Ryan, Jr., Sol. of Labor, Monica Gallagher, Associate Sol., and Norman P. Goldberg, Sherwin S. Kaplan and Jane M. Kheel, Attys., U. S. Dept. of Labor, Washington, D. C., of counsel), for plaintiff-appellee.

Raymond L. Falls, Jr., New York City (Cahill, Gordon & Reindel, David R. Hyde and P. Kevin Castel, New York City, of counsel), for defendants-appellants.

Before FRIENDLY and PIERCE, Circuit Judges, and METZNER,* District Judge.

FRIENDLY, Circuit Judge:

I. The Nature of the Action and the Proceedings in the District Court

This action was brought on October 19, 1981, by the Secretary of Labor (the Secretary) under § 502(e)(1) of the Employee Retirement Income Security Act of 1974 (ERISA), 29 U.S.C. § 1132(e)(1), in the District Court for the Eastern District of New York, against John C. Bierwirth, Robert G. Freese and Carl A. Paladino, Trustees of the Grumman Corporation Pension Plan (the Plan). The action stems from the unsuccessful tender offer by LTV Corporation (LTV) in the fall of 1981 for some 70% of the outstanding common stock and convertible securities of Grumman Corporation (Grumman) at $45 per share. At the time of the offer the Plan owned some 525,000 shares of Grumman common stock, which it had acquired in the mid-1970's. As hereafter recounted, the Plan not only declined to tender its stock but purchased an additional 1,158,000 shares at an average price of $38.27 per share, at a total cost of $44,312,380. These acts, the Secretary's complaint alleged, constituted a violation of §§ 404(a) and 406(b) of ERISA, 29 U.S.C. §§ 1104(a) and 1106(b) which we set out in the margin.[1]

Simultaneously with filing the complaint, the Secretary moved for a temporary restraining order and preliminary injunction, to prohibit the Trustees of the Plan from buying, selling or exercising any rights with respect to Grumman securities and to appoint a receiver for the securities already held by the Plan. On October 19 the motion for a temporary restraining order came on for hearing before Judge Mishler, who had already, on October 14, 1981, issued an order temporarily enjoining the tender offer because of inadequate disclosure and threatened violation of § 7 of the Clayton Act, *Grumman Corp. v. LTV Corp.*, 527 F.Supp. 86, which this court was later to affirm on November 13, 1981, 665 F.2d 10. Counsel appearing for the trustees agreed to maintain the *status quo* until the motion for a preliminary injunction and the appointment of a receiver could be brought on for hearing on October 30, 1981; on that basis the motion for a temporary restraining order was withdrawn. No testimony was taken at the October 30 hearing; the matter was submitted on affidavits, depositions, public filings and a stipulation of background facts. A number of participants in the Plan were allowed to intervene as defendants; a supporting affidavit of one of the Plan participants alleged that:

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* Honorable Charles M. Metzner of the United States District Court for the Southern District of New York, sitting by designation.

[1] § 1104. Fiduciary duties

(a) Prudent man standard of care

(1) Subject to sections 1103(c) and (d), 1342, and 1344 of this title, a fiduciary shall discharge his duties with respect to a plan solely in the interest of the participants and beneficiaries and—

(A) for the exclusive purpose of:

(i) providing benefits to participants and their beneficiaries; and

(ii) defraying reasonable expenses of administering the plan;

(B) with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims;

(C) by diversifying the investments of the plan so as to minimize the risk of large losses, unless under the circumstances it is clearly prudent not to do so; and

(D) in accordance with the documents and instruments governing the plan insofar as such documents and instruments are consistent with the provisions of this subchapter.

(2) In the case of an eligible individual account plan (as defined in section 1107(d)(3) of this title), the diversification requirement of paragraph (1)(C) and the prudence requirement (only to the extent that it requires diversification) of paragraph (1)(B) is not violated by acquisition or holding of qualifying employer real property or qualifying employer securities (as defined in section 1107(d)(4) and (5) of this title).

§ 1106. Prohibited transactions

(b) A fiduciary with respect to a plan shall not

(1) deal with the assets of the plan in his own interest or for his own account,

(2) in his individual or in any other capacity act in any transaction involving the plan on

> [S]pontaneously and within days after this suit was commenced, Grumman employees at all levels and in all departments began to circulate petitions expressing their approval of the trustees' actions, as participants in the Pension Plan. To date, petitions have been signed by approximately 17,000 of the 22,000 employees who are Plan participants and beneficiaries.

On December 3, 1981, the district court, 538 F.Supp. 463, rendered an opinion containing its findings of fact and conclusions of law. Joint App. 193a. After rejecting the Secretary's contention that the trustees committed *per se* violations of ERISA and making a detailed survey of the evidence, the judge concluded that the Secretary had "shown a likelihood of success on his claim that each of the trustees has acted imprudently with respect to their recent investment decisions concerning Grumman stock". He invited suggestions with respect to the form of preliminary relief. The trustees proposed that if the court felt it necessary to go beyond a preliminary injunction with respect to dealings in Grumman securities, it should adopt a proposal of the Grumman board, embodied in a resolution passed on December 17, 1981, that the board, with all management directors abstaining, should appoint three non-management directors as interim trustees. Declining this proposal the judge entered an order which preliminarily enjoined the trustees from buying, selling or exercising any rights with respect to Grumman securities except upon further order of the court and directed the appointment of a receiver to serve as an "Investment Manager" for Grumman securities owned by the Plan, with "power to sell, tender for sale, or otherwise dispose of all or part of such stock or securities." The order contained elaborate provisions concerning the qualifications, method of appointment and compensation of the Investment Manager. The provisions with respect to the Investment Manager were stayed on condition "that defendant promptly request and diligently pursue an expedited appeal" to this court, which was done.

II. The Facts

The LTV tender offer followed a scenario that has become familiar. On September 21, 1981, in the absence of defendant Bierwirth, Chairman of the Board of Grumman, who was on vacation, Joseph O. Gavin, Jr., President of Grumman, received a telephone call from Paul Thayer, Chairman of the Board and Chief Executive Officer of LTV, inviting him to discuss a possible merger. Gavin rejected the invitation. Evidently unsurprised, LTV, prior to the opening of trading on the New York Stock Exchange on September 23, issued a press

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behalf of a party (or represent a party) whose interests are adverse to the interests of the plan or the interests of its participants or beneficiaries, or

(3) receive any consideration for his own personal account from any party dealing with such plan in connection with a transaction involving the assets of the plan.

release announcing that it was planning to make a cash tender offer at $45 per share for up to 70% of Grumman's common stock and securities representing or convertible into common stock. According to the press release, the offer constituted "the first step in a plan to acquire 100% of the voting equity of the Grumman Corporation". On September 21 and 22 Grumman stock had sold on the New York Stock Exchange at prices ranging between 23⅞ and 27¼. Later in the morning of September 23 Grumman put out a release on the Dow Jones News Service in Bierwirth's name stating that the Grumman directors would promptly consider the proposed offer. The release noted that the board would "consider legal factors including antitrust implications,"[2] warned stockholders not to act hastily and said that Dillon, Read & Co. had been retained to provide advice regarding the LTV offer. On the same day LTV delivered to Bierwirth's office a letter expressing regret at the lack of a meeting in which LTV would have had an "opportunity to spell out in a personal way how ... combination would be beneficial to the shareholders, employees, and communities served by Grumman", and stating that "[t]he headquarters of a combined Grumman-Vought aerospace operation would be established in Bethpage, Long Island [Grumman's headquarters] under a top management team that would include you as CEO as well as Joe Gavin and George Skurla from Grumman and Bob Kirk from Vought." Thayer continued to hope for "the opportunity to explain to you in more detail the advantages of the synergistic combination" he had proposed and enclosed a copy of the press release.

The LTV offer was made on September 24. It was conditioned upon the tender of a minimum of 50.01% of Grumman's common stock and securities representing or convertible into common stock. The withdrawal/proration date was 12:01 A.M. on October 16, 1981; the termination date was 12:01 A.M. on October 23. Bierwirth cut short his vacation and reached the Grumman office at midday on September 24. Although SEC Rule 14e 2, 17 C.F.R. § 240.14e 2, gave the Grumman board 10 business days from the commencement of the offer to communicate its position, if any, the board lost no time in going into action. It met on September 25. By then the LTV offer had caused the price of Grumman stock to rise to a range of 32⅝ to 34¼. The board had before it a two page letter of Dillon, Read & Co., Inc., which had served Grumman as investment banker, stating in a conclusory fashion that it was "of the opinion that the offer is inadequate from a financial point of view to holders of the Grumman securities." The letter said this conclusion was based on

> certain information of a business and financial nature regarding Grumman which was either publicly available or furnished to us by Grumman and [on] discussions with the management of Grumman regarding its business and prospects.

The letter made no attempt at quantification of these factors, and no representative of Dillon, Read attended the meeting for questioning, although apparently there were some supporting financial materials available. Defendant Robert G. Freese had also prepared some projections which are not in the record. The board unanimously adopted a resolution to oppose the tender offer, and issued a press release to that effect, saying that the board had concluded that "the offer is inadequate, and not in the best interests of Grumman, its shareholders, employees or the United States."

On September 28 Grumman began the previously mentioned action which was to lead to the injunction of the tender offer. On the same day defendant Bierwirth, Chairman of the Board of Grumman, sent a letter to the company's shareholders seeking their help in defeating the offer. The letter stated:

> We're very optimistic about our chances of defeating the takeover bid. About a third of all shares are held by

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[2] These arose from the fact that one of LTV's subsidiaries was Vought Corporation which, like Grumman, was a manufacturer of military aircraft and airframe subassemblies.

> Grumman's employee investment and pension plans. These plans are managed by Grummanites who will look long and hard at how well their fellow members would be served by selling off Grumman stock. Much of the rest is owned by Grumman people who, I believe, understand their future is worth more than a quick return on a block of shares.

The reasons given for opposing LTV's offer were the inadequacy of the price and others, relating to the pension fund, set forth in the margin.[3] The letter concluded by announcing that "Grumman's management is totally committed to defeating this takeover attempt", and by pleading "If you own Grumman shares, don't sell out to LTV".

On September 30, at the invitation of George Petrilak, President of the Grumman Retirees Club, Bierwirth met with 300 retirees to discuss the LTV offer. An affidavit of Petrilak avers that "there was great concern expressed by the members as to the possible impact of LTV succeeding in their tender offer upon their pensions," and said that "[t]he overwhelming attitude of the retirees was 'what is good for Grumman is good for retirees' ". The Club purchased an advertisement appearing in Newsday, a Long Island newspaper, on October 13, headed

> Grumman retirees protect your pension.
>
> Do not tender your stock to LTV.

Expectably, Bierwirth spent about 90% of his time during the next fortnight in activity directed to opposing the LTV offer. Freese devoted at least half his time to arranging an "additional bank credit facility". This was done "without any specific plans as to the use of the proceeds" in order "to have as much borrowing capability as possible in the event the Board wanted to take some action. . . ." Two borrowings had been made as of the date Freese's deposition was taken. One was for "compensating balances that are required under the agreement itself"; the second was "to have the funds available to pay for . . . up to a million shares of Grumman common stock."

The Grumman Pension Plan, established in 1943, is a "defined benefit plan" within the meaning of § 3(35) of ERISA, 29 U.S.C. § 1002(35),[4] meeting the requirements for qualification under § 401(a) of the Internal Revenue Code and covering both salaried and hourly employees. Initially banking institutions had acted as trustees of the Plan. However, in 1973 Grumman adopted a policy of having officers of Grumman or its affiliates serve as trustees, as permitted by § 408(c)(3) of ERISA, 29 U.S.C. § 1108(c)(3). The trustees in the fall of 1981 were Bierwirth; Freese, chief financial officer of Grumman since 1972; and Carl A. Paladino, Treasurer of Grumman Aerospace Corporation since 1969. John Mullan, associate general counsel of Grumman, has served as counsel to the trustees and regularly attended their meetings. Sometime prior to January 1, 1975, the Plan had acquired 525,000 Grumman shares.

On September 28 Freese mentioned to Bierwirth that the trustees "are going to have to get together here at some point and decide what [to] do in regard to the holdings of Grumman stock." Bierwirth agreed and said he would call Paladino. During the next ten days, the three trustees had casual conversations as they happened to meet each other. Nothing was said about the Plan's buying Grumman shares and no financial data were assembled for the meeting. Bierwirth had been informed by Mullan that if LTV succeeded, it could "merge the pension Plan though it may take them some time" and also "could cancel the Plan to the extent that they eliminate the Fund although of course they would retain the corporate obligation to pay", and by unidentified other sources that changing the presumed earnings rate would permit the declaration of some of the fund as surplus and recapture for the corporation.

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[3] There's one other factor to keep in mind: your pension fund. It's Grumman's policy to fully fund its employee pension fund. In contrast, LTV's pension fund right now is underfunded by almost a quarter of a billion dollars. Grumman people could lose if the two funds were to be merged.

[4] Under a defined benefit plan, 29 U.S.C. § 1102(35), the sponsoring corporation fixes the benefit levels for employee pensions and, based upon actuarial assumptions concerning investment return, mortality rates and so forth, contributes funds to the plan sufficient to pay these benefits. See Note, Fiduciary Standards and the Prudent Man Rule Under the Employment Retirement Income Security Act of 1974, 88 Harv.L.Rev. 960, 961–62 (1975).

What occurred at the Plan trustees' meeting, which was held on October 7, was described in the depositions of the three trustees. Freese's is the most detailed; we shall follow it, with supplementation from the others when required. Mullan made a ten minute presentation dealing with ERISA, pointing out that the trustees' decisions "as far as the Grumman stock was concerned had to be predicated solely upon the best interests of the participants of the Plan". There was then a general discussion of how the trustees felt about LTV, the Dillon, Read opinion letter, and Freese's five year financial projections for Grumman. Elaborating on the discussion of LTV, Freese mentioned concern about the underfunding of "their pension plan", LTV's highly leveraged debt situation which would be aggravated by the need for borrowing to finance the acquisition of Grumman, contingent liability with respect to environmental problems and a large number of pending lawsuits and alleged SEC violations, all of which was revealed in a recent LTV prospectus.[5] The same information was contained in LTV's annual report and in its other publicly available filings. Freese expressed concern that the assumed rate of return used by LTV's pension plan was higher than that used by other companies and that LTV would have trouble making contributions to their pension plan. Bierwirth testified that the trustees "were aware of" a report about Grumman by Lehman Brothers Kuhn Loeb Inc. (Lehman Brothers). This report, dated July 8, 1981, which recommended purchase of Grumman common stock, then selling at $28 per share, projected a 1981 84 earnings progression of $2.75, $5.00, $6.50 and $7.50, and contained financial analysis supporting the estimates. The report's projection of greater sales was stated to be based primarily on "[i]ndications . . . that [President] Reagan's request [for increased expenditures for military aircraft] will be approved by Congress" and Grumman's "promising diversification into aerospace subcontracting . . . ."[6]

After a half hour's discussion the trustees voted not to tender the 525,000 Grumman shares held by the Plan. According to Bierwirth the trustees "then discussed whether we should take a second step. If we did not want to tender the stock at $45 a share, should we then consider buying additional shares, the market then being in the 30's?" A merit of such a purchase would be in making it more difficult for LTV to gain control of the pension fund. However, "it was also important that a further investment in Grumman shares be the right thing for us to do." "[A] number of fortuitous events had occurred during the summer and early in September which greatly enhanced the outlook for Grumman" and had made Bierwirth "feel earlier that a further investment in Grumman was desirable and should be recommended to the Trustees come this fall." While it had been "very difficult to accumulate substantial positions in Grumman stock", which ordinarily traded at volumes of 20,000 shares a day, the daily volume of half a million shares induced by the LTV offer made it "possible to accumulate a major position in Grumman stock without affecting the price all that much." Bierwirth was then of the view that "probably a majority of the stock would not be tendered" but could not feel confident about it. He recognized that if the LTV tender offer were abandoned, selling by arbitrageurs would push the price down. Following their discussion of these ideas, the trustees concluded that purchases of Grumman stock up to the maximum of 10% of the value of the Plan's assets permitted by § 407(a)(2) of ERISA, 29 U.S.C. § 1107(a)(2), would be prudent.

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[5] The prospectus, dated May 28, 1981 was in connection with a public offering of 4,000,000 shares of LTV of $24.50 per share. The syndicate managers were Lehman Brothers Kuhn Loeb Incorporated and Merrill Lynch White Weld Capital Markets Group. On September 24, 1981, the closing price of these shares was $14.75.

[6] The district judge erred in referring to this report as having been "prepared with LTV's unique financial position and business objectives in mind." It was an investment recommendation prepared by Christopher C. Demish of Lehman Brothers' Research.

Two steps were taken shortly after the meeting: Grumman applied to the SEC for an exemption from rule 10b-6, 17 C.F.R. § 240.10b-6, which was thought necessary to permit the Plan to purchase additional Grumman shares. Grumman and the trustees executed an amendment of the trust agreement adding a new paragraph which, among other things, provided that Grumman should indemnify and hold harmless each trustee from any liability or expense arising out of any act of failure to act pursuant to the trust unless the liability or expense resulted from willful misconduct or lack of good faith. Authorization of the planned purchases was deferred until the SEC had acted on Grumman's request for an exemption from SEC rule 10b-6. On October 8 a press release announced the decision of the trustees not to tender the Plan's shares.

The request to the SEC was granted on Friday, October 9. The trustees met briefly on Monday, October 12, and authorized the Plan's purchase of 1,275,000 additional Grumman shares—just short of ERISA's 10% limitation. A press release issued on October 13 stated that use of the authorization would increase the Plan's ownership of Grumman stock from 3.8% to approximately 8% of the outstanding fully diluted shares. The Plan, acting through Dillon, Read, purchased 958,000 shares at an average price of $38.61 per share on October 12 and an additional 200,000 shares on October 13 at an average price of $36.62, for a total cost of $44,312,380.

On the next day, October 14, as previously indicated, the district court temporarily enjoined the LTV offer, thereby drastically reducing its chances for success. The price of Grumman stock fell on October 15 to a range of 28¼-29½. After this court affirmed the temporary injunction, the price of Grumman shares was 28-28¾; the market value of the newly purchased shares was approximately $32,500,000. As this is written, the price is 26¼-26⅜.

III. The Scope of Review

Despite oft repeated statements that the issuance of a preliminary injunction rests in the discretion of the trial judge whose decisions will be reversed only for "abuse", a court of appeals must reverse if the district court has proceeded on the basis of an erroneous view of the applicable law, *Ring v. Spina*, 148 F.2d 647, 650 (2 Cir. 1945); *Carroll v. American Federation of Musicians*, 295 F.2d 484, 488-89 (2 Cir. 1961); *Douglas v. Beneficial Finance Co.*, 469 F.2d 453, 454 (9 Cir. 1972), or of the standards governing the granting or denial of interlocutory relief, *Exxon Corp. v. New York*, 480 F.2d 460, 464 (2 Cir. 1973); *Dino DeLaurentiis Cinematografica, S.p.A. v. D-150, Inc.*, 366 F.2d 373 (2 Cir. 1966). A line of cases in this circuit, apparently having its source in *Dopp v. Franklin National Bank*, 461 F.2d 873, 878-79 (1972), has gone beyond this and held that, even when the district court has not thus erred, where that court did not hear live witnesses, whose credibility played an essential part in its determination, and the case was decided on the basis of pleadings, affidavits and depositions, which the court of appeals is in as good a position as the district judge to read and interpret, the appellate court is not limited to reversal for abuse of discretion. The description of how far the limit is transcended has varied—the appellate court has "broader discretion on review", *Dopp, supra*, 461 F.2d at 879; it is "able to exercise its discretion and to review the papers *de novo*", *San Filippo v. United Brotherhood of Carpenters & Joiners*, 525 F.2d 508, 511 (2 Cir. 1975); it "is not limited to reviewing the district court's exercise of discretion", *Forts v. Ward*, 566 F.2d 849, 852 n.8 (2 Cir. 1977); it may exercise "full review", *Jack Kahn Music Co. v. Baldwin Piano & Organ Co.*, 604 F.2d 755, 758 (2 Cir. 1979); *Crouse-Hinds Co. v. Internorth, Inc.*, 634 F.2d 690, 701 n.19 (2

Cir. 1980); and it "may consider the record *de novo*", at least when mandatory relief changing the *status quo* has been granted, *Doe v. New York University*, 666 F.2d 761, 765 (2 Cir. 1981). Two recent opinions have suggested that the use of the power to go beyond the "abuse of discretion" standard is itself discretionary, *New York v. Nuclear Regulatory Comm'n*, 550 F.2d 745, 750–53 (2 Cir. 1977); *Vidal Sasson, Inc. v. Bristol-Myers Co.*, 661 F.2d 272, 276 n.9 (2 Cir. 1981), with the former suggesting some guidelines as to how the discretion should be exercised. Factors favorable to the exercise of appellate discretion to engage in full review are that interlocutory relief has been granted rather than denied, lack of specificity in the findings of the trial court, and "defects, apart from the findings themselves, in the district court proceedings, which this court apparently believed justified a broader review of the lower court's proceedings. . . ."[7]

Whatever the end of this debate may be, we think this case is peculiarly one for applying a broad standard of review. The district judge's decision hinged on his view that ERISA imposed a high standard of fiduciary duty on the defendants. If he set the hurdle too high, his result could well be wrong. Judge Mishler did not consider that he was exercising discretion in finding that the trustees had violated their fiduciary duties; he regarded that conclusion as compelled. There is no real dispute over what did and what did not occur. The quarrel is over the legal standard and its application to facts not seriously in dispute. Thorough review at this point should be helpful not only to the parties but to the district judge in indicating the points that deserve further exploration at the trial. Moreover, the question here at issue can arise for other companies. We would ill perform our duties by a decision affirming the district court because of limitations on the scope of review, thereby necessarily implying that we would equally have upheld a contrary ruling.

IV. The Legal Standard

[1] We deal first with the contention, advanced by the Secretary in passing, that the result reached by the district judge was compelled on a ground rejected by him, namely, that the trustees, at least in their purchase of Grumman stock, violated the specific prohibitions of § 406(b) of ERISA. The only such prohibition that is arguably applicable is § 406(b)(2), see note 1 *supra*.

We hold that the section does not apply. The "party" that the trustees are claimed to have been acting on the behalf of or to have been representing presumably is Grumman. We read this section of the statute as requiring a transaction between the plan and a party having an adverse interest. Such was the case in the only appellate decision cited to us by the Secretary, *Cutaiar v. Marshall*, 590 F.2d 523, 529 (3 Cir. 1979). This also was true in *Freund v. Marshall & Ilsley Bank*, 485 F.Supp. 629 (W.D.Wis. 1979). *Marshall v. Kelly*, 465 F.Supp. 341 (W.D.Okl.1978) and *Gilliam v. Edwards*, 492 F.Supp. 1255 (D.N.J.1980), also cited by the Secretary, were cases of self-dealing clearly prohibited by § 406(b)(1). We see no reason to think Congress intended the expansive interpretation of the various specific prohibitions of § 406 urged by the Secretary, particularly in light of the inclusion of the sweeping requirements of prudence and loyalty contained in § 404.

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[7] Judge Oakes' opinion in the *Nuclear Regulatory* case pointed out that the principle of broader review of the grant or denial of preliminary injunctions where no live testimony was heard is closely related to the view taken by this court in *Orvis v. Higgins*, 180 F.2d 537, 539–40 (2 Cir.) (Frank, J.), *cert. denied*, 340 U.S. 810, 71 S.Ct. 37, 95 L.Ed. 596 (1950), with respect to the diminished effect of F.R.Civ.P. 52(a) in such cases and cited a statement in *Pan American World Airways, Inc. v. Aetna Casualty & Surety Co.*, 505 F.2d 989, 1004 (2 Cir. 1974), that:

> *Orvis* stands for the proposition that a record consisting only of pleadings, depositions, and affidavits may, at the reviewing court's discretion, be reviewed de novo.

However, the *Pan American* case was one where "a great deal of the evidence" consisted of oral testimony, *id.*, and the characterization of the proposition stated by *Orvis* as discretionary thus was dictum.

Sections 404(a)(1)(A) and (B) impose three different although overlapping standards. A fiduciary must discharge his duties "solely in the interests of the participants and beneficiaries." He must do this "for the exclusive purpose" of providing benefits to them. And he must comply "with the care, skill, prudence, and diligence under the circumstances then prevailing" of the traditional "prudent man".

The trustees urge that the mandates of § 404(a)(1)(A) and (B) must be interpreted in the light of two other sections of ERISA. One is § 408(c)(3), 29 U.S.C. § 1108(c)(3), which permits the appointment of officers of the sponsoring corporation as trustees. The other is § 407(a)(3), 29 U.S.C. § 1107(a)(3), which, as here applicable, permitted the Plan to acquire Grumman stock having an aggregate fair market value not exceeding 10% of the fair market value of the assets of the Plan. This provision, the trustees point out, was the result of a lengthy debate in which the Department of Labor played an important role; they rely especially on the following passage from its statement to the Senate Finance Committee:

> Especially significant among the expressly allowed transactions is that which permits, in most types of plans, investment of up to ten percent of the fund assets in securities issued by the employer of the employees who are participants in the plan. Since such an employer will often be an administrator of his plan, or will function as a trustee or in some other fiduciary capacity, this provision creates a limited exception to the listed proscription against self-dealing. The exception is made in recognition of *the symbiotic relationship* existing between the employer and the plan covering his employees. *Private Pension Plan Reform: Hearings Before the Subcomm. on Private Pension Plans of the Senate Comm. on Finance*, 93 Cong., 1st Sess. 446 (1973) (statement of Department of Labor) (emphasis supplied).

Appellants do not contend that these provisions relieve corporate officers or directors who are trustees of a plan of the duties imposed by § 404(a) when dealing with stock of the corporation which is an asset of the Plan. They argue rather that, despite the words "sole" and "exclusive", such officers or directors do not violate their duties by following a course of action with respect to the plan which benefits the corporation as well as the beneficiaries.

[2] We accept the argument but not the conclusion which appellants seem to think follows from it. Although officers of a corporation who are trustees of its pension plan do not violate their duties as trustees by taking action which, after careful and impartial investigation, they reasonably conclude best to promote the interests of participants and beneficiaries simply because it incidentally benefits the corporation or, indeed, themselves, their decisions must be made with an eye single to the interests of the participants and beneficiaries. Restatement of Trusts 2d § 170 (1959); II Scott on Trusts § 170, at 1297–99 (1967) (citing cases and authorities); Bogert, The Law of Trusts and Trustees § 543 (2d ed. 1978). This, in turn, imposes a duty on the trustees to avoid placing themselves in a position where their acts as officers or directors of the corporation will prevent their functioning with the complete loyalty to participants demanded of them as trustees of a pension plan.

[3] There is much to be said for the Secretary's argument that the participation of Bierwirth and Freese in the directors' decision of September 25 press release announcing the unanimous decision of the board to do this on the ground, *inter alia*, of its inadequacy; the sending of Bierwirth's letter of September 28 repeating this and also announcing that the LTV offer was a threat to the pension fund; and the other activities of Bierwirth and Freese in opposing the offer precluded their exercising the detached judgment required of them as trustees of the Plan, and that the only proper course was for the trustees immediately to resign so that a neutral trustee or trustees could be swiftly appointed to serve

for the duration of the tender offer.[8] Looking at the matter realistically we find it almost impossible to see how Bierwirth and Freese, after what they had said and done between September 24 and October 7, could have voted to tender or even to sell the Plan's stock, no matter how compelling the evidence for one or the other of those courses might have been.[9] Grumman shareholders who had acted in accordance with the company's pleas would have had every reason to consider such action a breach of faith. Even though the district judge had not seen or heard Freese, he was not required to accept Freese's deposition testimony that his mind "was not absolutely made up" until he got to the October 7 meeting and that he "hadn't predecided" what his answer would be. "[W]e are not to close our eyes as judges to what we must perceive as men." *People ex rel. Alpha Portland Cement Co. v. Knapp*, 230 N.Y. 48, 63, 129 N.E. 202, 208 (1920) (Cardozo, J.), *cert. denied sub nom. State Tax Commissioner v. People ex rel. Alpha Portland Cement Co.*, 256 U.S. 702, 41 S.Ct. 624, 65 L.Ed. 1179 (1921). In this respect, as in others, the case differs vitally from *Withers v. Teachers' Retirement System*, 447 F.Supp. 1248 (S.D.N.Y.1978) (Conner, J.), *aff'd mem.*, 595 F.2d 1210 (2 Cir. 1979), on which the trustees heavily rely.

We are not, however, required to go so far in this case. The record contains specific instances of the trustees' failure to observe the high standard of duty placed upon them. Bierwirth and Freese should have been immediately aware of the difficult position which they occupied as a result of having decided as directors some of the same questions they would have to decide as trustees, and should have explored where their duty lay.[10] Instead the question of a trustees' meeting was treated quite casually—something to be attended to when the hectic pace of fighting the tender offer would permit. One way for the trustees to inform themselves would have been to solicit the advice of independent counsel; Mullan, a junior Grumman employee, was under disabilities similar to those of the trustees themselves. He could hardly have been expected to tell the trustees that the better course would be to resign or even to suggest investigations which might alter the judgment of total commitment to defeating the LTV offer that management had already expressed. We do not mean by this either that trustees confronted with a difficult decision need always engage independent counsel or that engaging such counsel and following their advice will operate as a complete whitewash which, without more, satisfies ERISA's prudence requirement. But this was, and should have been perceived to be, an unusual situation peculiarly requiring legal advice from someone above the battle.

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[8] It could be said against this that Bierwirth and Freese were fiduciaries for the Grumman stockholders and that if their actions before the trustees' meeting on October 7 met their duties as such, no harm was done by their prejudgment. However, as Justice Frankfurter observed in a famous passage, "to say that a man is a fiduciary only begins analysis; it gives direction to further inquiry. To whom is he a fiduciary? What obligations does he owe as a fiduciary?" *SEC v. Chenery Corp.*, 318 U.S. 80, 85-86, 63 S.Ct. 454, 458, 87 L.Ed. 626 (1943). The fiduciary obligations of the trustees to the participants and beneficiaries of the plan are those of trustees of an express trust—the highest known to the law. Restatement of Trusts 2d § 2, comment b (1959). The trustees do not even contend that the quick judgment made at the directors' meeting of September 25 satisfied their obligations under § 404(a)(1)(A) and (B). Whether it satisfied their obligations to Grumman shareholders is not before us.

[9] We are not impressed with the defendants' argument that they, and particularly Bierwirth, had nothing to fear from the LTV offer in light of LTV's announced intention to make Grumman's office the headquarters of its aerospace division and to retain Bierwirth as C. E. O. of that division. No offer was made with respect to Freese or Paladino. Even as to Bierwirth there have been countless instances where, even when a proposal to retain the chief executive of the target was wholly sincere, he will have disappeared within a year or so. Moreover, being C. E. O. of a division of LTV was not the same thing as being C. E. O. of an independent Grumman. The press currently recounts how high corporate executives are equipping themselves with "golden parachutes" providing large benefits in the event that the executive is dismissed or even if he quits on his own volition after a takeover.

[10] Bierwirth was a law school graduate and had practiced for 3 years.

The trustees also failed to measure up to the standard required of them in failing to do a more thorough job in ascertaining the facts with respect to the LTV pension funds, the unfunded liabilities of which were to be a principal ground for their action, and investigating whether anything could be done to protect the Grumman pension fund in the event of an acquisition of Grumman by LTV. So far as the record show, the sole knowledge the trustees had of the LTV pension plans came from two portions of the prospectus for the May 28, 1981, LTV stock offering which we set forth in the margin.[11] The September 28 letter from Bierwirth to Grumman's shareholders drew on the prospectus' statement about unfunded liabilities but eliminated the phrase "which relates primarily to unfunded vested pension liabilities assumed in the purchase of Lykes". The omission of this clause was important because it created the false impression, on the basis of which the trustees could well have acted, that LTV had a single pension fund which had unfunded liabilities in the considerable amount stated. If, as the prospectus foreshadowed and investigation would have confirmed, the unfunded liabilities were principally in pension funds covering hourly employees of LTV's steel operations,[12] the danger of these plans being merged with Grumman's was considerably less than if LTV had a single underfunded pension fund.

The trustees' perception of danger would have been reduced yet further had they known that LTV treated a number of the 21 pension plans which it sponsored quite well. For example, the pension plan for salaried Vought employees was extremely well-funded, with an excess of current assets over vested liabilities of approximately $78,000,000. Other Vought plans, including one covering hourly workers, had not been treated so favorably, but nonetheless were in better financial condition than LTV's plans for employees in the steel industry. The means for the trustees to conduct speedy investigation were readily at hand. The trustees knew that LTV was obliged to file with the Internal Revenue Service and the Secretary of Labor reports (Form 5500's) with respect to each of its pension funds. They made no effort to examine these. Counsel tells us that examination of the reports would have shown the unfunded

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[11] Retirement Plans

The Company has retirement plans covering substantially all of its employees. It is the policy to accrue retirement costs, including amortization (primarily over 40 years) of prior service costs. Contributions are made to Company sponsored retirement plans in accordance with the minimum funding requirements of the Employee Retirement Income Security Act of 1974, and to multi-employer plans as required by collective bargaining agreements for the Company's seagoing, longshore and mining employees.

Note G—Employee Compensation and Benefits

Included in the noncurrent liability for employee compensation and benefits was approximately $225,000,000 and $227,000,000 at December 31, 1980 and 1979, respectively, which relates primarily to unfunded vested pension liabilities assumed in the purchase of Lykes.

Costs under retirement plans were $167,600,000 in 1980, $167,300,000 in 1979 and $95,100,000 in 1978. The accumulated plan benefits and plan net assets for the Company's defined benefit plans as of the most recent date (January 1, 1980) were as follows (in thousands):

Actuarial present value of vested accumulated plan benefits	$1,322,313
Net assets available for plan benefits	1,273,505
Excess	$ 48,808
Actuarial present value of nonvested accumulated plan benefits	$ 166,059

The weighted average assumed rate of return used in determining the actuarial present value of accumulated plan benefits was 10 percent. The actuarial present values of accumulated plan benefits of the Company's seagoing, longshore and mining employees covered by multi-employer plans are not currently determinable.

As mentioned above, similar information appeared in LTV's annual report and its other publicly available filings.

[12] Even at the time of his deposition Paladino did not know which of LTV's plans had the unfunded liabilities.

liabilities to have been even greater than disclosed in the prospectus, an aggregate of approximately $378,000,000 rather than $225,000,000, as of December 31, 1980. Apart from Judge Mishler's observation that "Luck or good fortune is no substitute for a trustee's duty of inquiry," the investigation would have shown also that LTV maintains separate pension plans for employees in different industries and some 93% of the unfunded liabilities were in the pension funds covering LTV's steel operations, which there would have been reasons to believe posed little danger to the Grumman Plan.[13] Further inquiry in these areas, as well as those mentioned immediately below, might well have changed the trustees' views regarding both the danger presented by LTV's offer to the Plan and their ability to obtain satisfactory protections from LTV for the Plan. In addition, even if the trustees' beliefs regarding the financial condition of LTV's pension plans and LTV's policies towards its plans had been entirely accurate, we see little in the record to indicate that they attempted to determine just what LTV could have done and could not have done to inflict financial harm upon the participants in Grumman's Plan.[14] The trustees easily could have retained an expert on ERISA to advise them on this subject.

The trustees were also too cavalier in their treatment of public statements by LTV that it did not intend to touch the Plan. To be sure, as Bierwirth testified, very few assurances could be proof against serious financial difficulties of LTV. Nonetheless, the trustees were bound to take LTV up on its statements and see how far, if at all, it was willing to place these in binding form. If it was, that would have gone at least part of the way in alleviating the trustees' concerns; if it was not, its refusal would have confirmed them. It is true that even if LTV had been completely forthcoming the trustees might still have been justified in concluding that its debt-ridden balance sheet was a sufficient basis for concern, but they would have reached that conclusion after having made every reasonable effort to see how much protection LTV would have afforded—a question which likely can no longer be answered. See *Withers v. Teacher's Retirement System, Inc., supra,* 447 F.Supp. at 1259.

However, we are not obliged to decide whether the district court would have been justified in awarding preliminary injunctive relief on these facts alone. An even more telling point against the trustees is their swift movement from a decision not to tender or sell[15] the shares already in the fund to a decision to invest more than $44,000,000 in the purchase of additional Grumman shares up to the 10% maximum permitted by § 407(a)(2) of ERISA. Their argument is that once they had reasonably decided not to tender the shares already in the fund since success of the offer would run counter to the interests of the beneficiaries, it followed that they should do everything else they lawfully could do to thwart the offer. This, however, should have involved a calculation of the risks and benefits involved. Bierwirth properly conceded that a further investment in Grumman shares had to be "the right thing for us to do." The trustees' consideration of this was woefully inadequate. Although Grumman shares may have seemed attractive when selling in the high 20's, with what appeared a good chance of appreciation, see note 6 *supra* and accompanying text, they were not necessarily attractive when, under the impetus of the tender offer, they had risen to the high 30's. Moreover, and even more important, in purchasing additional shares when they did, the trustees were buying into what, from their own point of view, was almost certainly a "no-win" situation. If the LTV offer succeeded, the Plan would be left as a minority stockholder in an LTV-controlled Grumman—a point that seems to have received no consideration. If it failed, as the Plan's purchase of additional 8% of the outstanding Grumman stock made more likely, the stock was almost certain to sink to its pre-offer level, as the trustees fully appreciated. Given the trustees' views as to the dim future of an LTV-controlled Grumman, it is thus exceedingly difficult to accept Bierwirth's testimony that the purchase of additional shares was justified from an investment standpoint—or even to conclude that the trustees really believed this. Investment considerations dictated a policy of waiting. If LTV's offer were accepted, the trustees would not want more Grumman shares; if it failed, the shares would be obtainable at prices far below what was paid. Mid-October 1981 was thus the worst possible time for the Plan to buy Grumman stock as an investment.[16] It is almost impossible to believe that the trustees did not realize this and that their motive for purchasing the additional shares was for any purpose other than blocking the LTV offer. Moreover, even if we were to make the dubious assumption that a purchase for this purpose would have been permissible despite all the investment risks that it entailed, the trustees should at least have taken all reasonable steps to make sure the purchase was necessary. As indicated, Bierwirth was under the impression that the necessary 50.01% would not be tendered—an expectation not unnatural in view of the fact that Grumman's investment and pension plans already owned nearly a third of the shares—although he could not be sure. The record gives no explanation why, if additional shares were to be purchased, this could not have been done by Grumman, in some way that would not reduce the number of outstanding shares, with the bank credit Freese had negotiated in part for that very purpose, rather than by the Plan. There is also nothing to indicate that the trustees, or other Grumman officers or directors, had been willing to risk their own funds in buying additional Grumman shares in the interval before the Plan was free to act. While the trustees did wait over the week-end of October 10 and 11 to see whether the judge's decision on Grumman's application for a preliminary injunction would come down, there is nothing to indicate any effort to ascertain from the judge's chambers when this could be expected, although such an inquiry would have been entirely proper. To be sure, the trustees could not have foretold what the decision would have been but if they had known that it was expected to be filed on October 14, they could well have decided to postpone the expenditure of $44,000,000 of the Plan's money in buying Grumman shares even if denial of the injunction might have somewhat increased the price of the stock.

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[13] The trustees might also have inquired whether, as an affidavit submitted on behalf of the Secretary asserts, Joint App. 164a–65a, the unfunded liabilities relating to LTV's steel operations were attributable to causes other than LTV's particular policies.

[14] Counsel for the trustees argue that LTV could have merged the Grumman plan with an LTV plan, appointed new trustees, terminated the Grumman plan, and so forth. ERISA, of course, contains elaborate safeguards to protect employees from the financial consequences of such actions, *e.g.*, 29 U.S.C. §§ 1058, 1342, 1344; IRC §§ 411, 412, 414. Counsel for the trustees have not suggested how LTV could have avoided such safeguards, much less that the trustees seriously considered these factors in making their decision at the October 7 meeting.

[15] The record does not indicate that sale was even considered, although that course had some attractions. It would have eliminated the possibilities that if the Plan did not tender and the offer succeeded, the Plan might be left as a minority stockholder in an LTV controlled Grumman, and that, if the Plan did tender and the offer succeeded, the Plan might be left with some Grumman stock, because of the 70% maximum in the tender offer.

We do not join in all of the district judge's pejorative adjectives concerning the trustees. They were caught in a difficult and unusual situation—apparently, so far as shown in the briefs, one that had not arisen before. We accept that they were honestly convinced that acquisition of Grumman by the debt-ridden LTV would mean a less bright future for Grumman and also that an LTV acquisition posed some special dangers to the participants of the Plan.[17] However, they should have realized that, since their judgment on this score could scarcely be unbiased, at the least they were bound to take every feasible precaution to see that they had carefully considered the other side, to free themselves, if indeed this was humanly possible, from any taint of the quick negative reaction characteristic of targets of hostile tender offers displayed at the September 24 board meeting, and particularly to consider the huge risks attendant on purchasing additional Grumman shares at a price substantially elevated by the tender offer. We need not decide whether even this would have sufficed; perhaps, after the events of late September, resignation was the only proper course. It is enough that, for the reasons we have indicated, as well as others,[18] the district judge was warranted in concluding, on the materials before him, that the trustees had not measured up to the high standards imposed by § 404(a)(1)(A) and (B) of ERISA. How the situation will appear after a trial is a different matter which we cannot now decide.

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[16] The judge was not bound to accept the trustees' claim that purchases of considerable amounts of Grumman stock could not be made (and that their failure to purchase Grumman stock earlier although their belief in its attractiveness was claimed to go back to the summer of 1981 was thereby explained) on the ground that, with a daily volume of only 20,000 shares, substantial purchases would have greatly increased the price. No expert testified to that effect and no explanation was offered how the Plan had managed to accumulate 525,000 shares when, as Bierwirth stated, the market had been much thinner. Even if we assume that a carefully executed buying program would have somewhat boosted the price, there was no testimony that this would have been anything like the increase of ten points that had resulted from LTV's $45 offer.

Relief

[4] Not seriously disputing that if interlocutory relief is to be granted, the preliminary injunction embodied in Part I of the court's order of January 13, 1982, was appropriate, the trustees challenge the propriety of Part II directing the appointment of an Investment Manager to act as receiver *pendente lite*. They insist that the Investment Manager is in fact a partial trustee; that, under § 7.01 of the Plan and §§ 2(c) and 10 of the Trust Agreement, new trustees can be appointed only by the Grumman board; and that the proposal for the appointment by the nonmanagement directors of three of their number as interim trustees filled whatever need there was to replace the existing trustees.

Although ERISA does not provide specifically for the appointment of a receiver in an action by the Secretary under § 1132(a)(5), such power is conferred by the provision authorizing him to seek "other appropriate equitable relief." See *Marshall v. Snyder*, 572 F.2d 894, 901 (2 Cir. 1978). The contention that in exercising this power a court is constrained by the provisions of a plan does not require comment. See Restatement of Trusts 2d § 199d, Comment d (1959). Still the appointment of a receiver is a harsh remedy, not to be imposed without a showing of necessity.

We fail to see why Part I of the order of January 11, 1982, does not sufficiently protect the situation during the interval before final judgment can be entered. This enjoins the trustees from "buying, selling or exercising any powers, rights or other duties on behalf of said Pension Plan regarding stock or other securities issued by the Grumman Corporation except upon the further Order of this Court," which, we assume, would have to be made on notice to the Secretary. We also read the order as preventing a decision not only to tender but a decision not to tender, except upon the further order of the court, if there should be a new tender offer; if the Secretary considers this to be doubtful and the trustees should refuse to make an appropriate stipulation, the court can clarify its order. The financial integrity of the trustees is not questioned, as is demonstrated by the court's willingness that they continue to act as such with respect to more than 90% of the Plan's assets. The only added benefits from the appointment of an Investment Manager are that he would be free to take initiatives, e.g., selling Grumman securities, that might not be taken by the trustees; that the presence of the Investment Manager might stimulate a new and advantageous tender offer; and that if such an offer should be made, which no one has suggested to be likely, the Manager would be in place. These benefits do not warrant the disruption and expense which the appointment would cost for what should be a short period. We therefore modify the order by striking Part II, without prejudice to the right of the Secretary to move for relief similar to that therein provided if there should be another tender offer prior to the entry of final judgment.

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[17] These dangers included the low level of pension benefits allegedly maintained by LTV; the fact that while LTV complied only with the minimum funding requirements of ERISA, Grumman contributed the impliedly higher amount of the maximum amount deductible under the IRC; the fact that LTV could merge or terminate the Plan; the near certainty that LTV would appoint new trustees for the Plan; and the danger that, even if it had the best of intentions towards the Grumman Plan, LTV's financial condition might preclude it from treating the Plan favorably.

[18] For example, the sudden desire for indemnity before the purchase was authorized.

The order is modified as stated in the foregoing portion of this opinion and, as so modified, is affirmed. The Secretary may recover 80% of his costs.

Raymond J. DONOVAN, Secretary of the United States Department of Labor, Plaintiff,

v.

John C. BIERWIRTH, Robert G. Freese and Carl A. Paladino, Defendants.

Joseph W. Ullman, Lillian E. Baldissard, Rita V. Hafner, Anthony Pancella, Jr., Kathleen T. Chew and Benjamin L. Crews, Intervenor-Defendants.

No. 81 CV 3408.

United States District Court,
E. D. New York.

Dec. 3, 1981.

An action was instituted by the Secretary of Labor against the trustees of a pension plan to enjoin acts and practices which were allegedly in violation of the Employee Retirement Income Security Act. The District Court, Mishler, J., held that: (1) individuals with dual capacities as trustees of pension plan and officers of sponsor corporation did not commit per se violations of Act at time of tender offer either by their failure to abstain from investment decision concerning stock of corporation or by mere acquisition of that stock, and (2) decision on part of trustees to expend assets of plan for purchase of stock of sponsor corporation in an effort to fend off a tender offer was made without sufficient inquiry into facts upon which it was based and, when motivated solely by an all consuming desire to defeat tender offer, was violative of duty of prudence under Act because it evinced an inability to make an independent decision on behalf of pension plan solely in interest of participants and beneficiaries.

Order accordingly.

Affirmed as modified, 2d Cir., 680 F.2d 263.

1. Master and Servant ⇨78.1(7)

Provisions of the Employee Retirement Income Security Act necessarily contemplate that trustees, who may be officers of the sponsoring company, may act on behalf of the pension plan in making investment decisions concerning stock of the sponsor corporation in spite of a potential conflict of interests. Employee Retirement Income Security Act of 1974, §§ 406, 407, 408(c)(3), 29 U.S.C.A. §§ 1106, 1107, 1108(c)(3).

2. Master and Servant ⇨78.1(7)

Although a trustee of a pension fund may have dual loyalties when he also acts as officer of the sponsor corporation, when acting on behalf of the fund, his primary loyalty to the fund is the only loyalty which may affect his judgment. Employee Retirement Income Security Act of 1974, §§ 406, 407, 408(c)(3), 29 U.S.C.A. §§ 1106, 1107, 1108(c)(3).

3. Master and Servant ⇨78.1(7)

A trustee may invest in stock of sponsor corporation in spite of his dual loyalties and conflicting interests so long as he acts exclusively for the benefit of the plan beneficiaries and participants and otherwise complies with the statutory proscriptions. Employee Retirement Income Security Act of 1974, §§ 406, 407, 408(c)(3), 29 U.S.C.A. §§ 1106, 1107, 1108(c)(3).

4. Master and Servant ⇨78.1(7)

A trustee who has dual loyalties to the pension plan and the sponsor corporation has an especial obligation to act fairly on behalf of those concerned with the results of the action taken. Employee Retirement Income Security Act of 1974, §§ 406, 407, 408(c)(3), 29 U.S.C.A. §§ 1106, 1107, 1108(c)(3).

5. Master and Servant ⇨78.1(7)

Individuals with dual capacities as trustees of pension plan and officers of sponsor corporation did not commit per se violations of Employee Retirement Income Security Act at time of tender offer either by their failure to abstain from investment decision concerning stock of corporation or by mere acquisition of that stock. Employee Retirement Income Security Act of 1974, §§ 406, 407, 408(c)(3), 29 U.S.C.A. §§ 1106, 1107, 1108(c)(3).

6. Master and Servant 🔑78.1(7)

Affirmative duty under the Employee Retirement Income Security Act to act with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims subsumes the duty to make an independent inquiry into the merits of a particular investment decision. Employee Retirement Income Security Act of 1974, § 404(a)(1)(B), 29 U.S.C.A. § 1104(a)(1)(B).

7. Master and Servant 🔑78.1(7)

A review of a fiduciary's independent investigation is one of the well-established yardsticks against which courts have customarily tested fiduciary conduct for prudence. Employee Retirement Income Security Act of 1974, § 404(a)(1)(B), 29 U.S.C.A. § 1104(a)(1)(B).

8. Master and Servant 🔑78.1(7)

When a fiduciary under the Employee Retirement Income Security Act has dual loyalties, his independent investigation into the basis for an investment decision which presents a potential conflict of interests must be both intensive and scrupulous and must be discharged with the greatest degree of care that could be expected under all the circumstances by reasonable beneficiaries and participants of the plan. Employee Retirement Income Security Act of 1974, § 404(a)(1)(B), 29 U.S.C.A. § 1104(a)(1)(B).

9. Master and Servant 🔑78.1(7)

Even a good-faith belief held by trustees with dual loyalties under the Employee Retirement Income Security Act does not insulate them from charges that they have acted imprudently. Employee Retirement Income Security Act of 1974, § 404(a)(1)(B), 29 U.S.C.A. § 1104(a)(1)(B).

10. Master and Servant 🔑78.1(7)

It was no defense to the asserted violation of the Employee Retirement Income Security Act that the decision of the trustees with dual loyalties to fight the tender offer for the stock of the sponsor corporation with assets of the pension plan was in the best interests of the plan if the decision was arrived at without a thorough independent investigation of the basis for the decision. Employee Retirement Income Security Act of 1974, § 404(a)(1)(B), 29 U.S.C.A. § 1104(a)(1)(B).

11. Master and Servant 🔑78.1(7)

Decision on part of trustees of pension plan with dual loyalties to expend assets of plan for purchase of stock of sponsor corporation in an effort to fend off a tender offer was made without sufficient inquiry into facts upon which it was based and, when motivated solely by an all consuming desire to defeat tender offer, was violative of duty of prudence under Employee Retirement Income Security Act because it evinced an inability to make an independent decision on behalf of pension plan solely in interest of participants and beneficiaries. Employee Retirement Income Security Act of 1974, § 404(a)(1)(B), 29 U.S.C.A. § 1104(a)(1)(B).

12. Master and Servant 🔑78.1(7)

Preliminary relief is available under the Employee Retirement Income Security Act upon a finding that a fiduciary has breached responsibilities, obligations or duties thereunder. Employee Retirement Income Security Act of 1974, § 409(a), 29 U.S.C.A. § 1109(a).

13. Master and Servant 🔑78.1(7)

Factors to be considered in determining feasibility of preliminary relief under Employee Retirement Income Security Act include the purposes of the trust, the relative pecuniary advantage to the trust estate of the various remedies, the nature of the interest of each beneficiary, the practical availability of the various remedies, and the extent of the deviation from the terms of the trust required by adoption of each of the remedies. Employee Retirement Income Security Act of 1974, § 409(a), 29 U.S.C.A. § 1109(a).

14. Master and Servant 🔑78.1(7)

Given failure of trustees of pension fund to discharge their duty of prudence under Employee Retirement Income Security Act either diligently or in good faith, district court, pending further proceedings to fashion preliminary relief which would most suitably promote interests of pension plan, its participants and its beneficiaries, would enter an order restraining trustees from buying, selling or exercising any powers, rights or other duties on behalf of pension plan with respect to stock or other security issued by sponsor corporation except upon written consent of the Secretary of Labor. Employee Retirement Income Security Act of 1974, § 409(a), 29 U.S.C.A. § 1109(a).

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Memorandum of Decision and Order

MISHLER, District Judge.

Plaintiff Raymond J. Donovan, the Secretary of Labor (the "Secretary"), brings this action under the Employee Retirement Income Security Act of 1974 ("ERISA"), 29 U.S.C. § 1001 *et seq.*, against the three trustees of the Grumman Corporation Pension Plan (the "Pension Plan") to, *inter alia*, enjoin acts and practices violative of Title I of ERISA and secure other appropriate equitable relief. The gravamen of plaintiff's complaint alleges that each of the individual trustees have breached their fiduciary duties by expending Pension Plan assets for the purchase of Grumman Corporation stock in an effort to fend off the tender offer made for the Grumman Corporation ("Grumman") by The LTV Corporation. ("LTV"). The details of those open market purchases made by the Pension Plan on October 12 and 13, 1981 have been recounted in a recent decision by this court, *The LTV Corporation v. Grumman Corporation*, 526 F.Supp. 106 (E.D.N.Y. 1981). For the purposes of presentation, we shall once again review the details of those purchases and examine the decision-making process which led to the purchase decision.

The material facts are either conceded or beyond dispute, and accordingly, this motion did not necessitate an evidentiary hearing. The court has thoroughly reviewed the exhibits and depositions submitted at the time of argument on October 30, 1981 and now makes the following findings of fact and conclusions of law as required by Rule 52(a) of the Federal Rules of Civil Procedure.

I. FACTS

On September 24, 1981, The LTV Corporation publicly announced that it was making a tender offer for up to 70% of the Grumman Corporation's outstanding stock and securities convertible into stock conditioned upon acquiring at least 50.01% of Grumman stock on a fully diluted basis. On the day prior to the announcement, Grumman's Chief Executive Officer and Chairman of the Board of Directors, John C. Bierwirth, was informed of LTV's intentions while vacationing on the Mississippi River. He returned to Grumman headquarters at Bethpage, New York midday on the 24th. He did not confer with Grumman personnel concerning the LTV offer until his return. The Grumman Board of Directors convened September 25 and passed a resolution to fight the takeover. Thus, the commencement of Grumman's well orchestrated plan to defeat the LTV tender offer was set into motion.

The Pension Plan held 525,000 shares of Grumman stock prior to the October purchases. The market value of that investment immediately before the tender offer (at $25 per share) was approximately $13,-

125,000. LTV's offer to purchase Grumman stock for $45 per share presented the Pension Plan with the possibility of realizing a substantial gain on its Grumman investments.

Three days after the Board's decision to oppose the LTV takeover, Mr. Bierwirth, acting as Chairman of the Board, in a letter directed to "Fellow Grummanite(s)," observed the following:

> We're very optimistic about our chances of defeating the takeover bid. About a third of all shares are held by Grumman's employee investment and pension plans. These plans are managed by Grummanites who will look long and hard at how well their fellow members would be served by selling off Grumman stock.

It was indeed the obligation of the Pension Plan trustees to take a long hard look at how the Plan would be served by tendering its Grumman stock.

Mr. Bierwirth spent approximately 90% of his working hours during the two-week period following his return to Long Island trying to understand the LTV offer and simultaneously denouncing it through public meetings with reporters, employees and retirees. His decision as a trustee of the Pension Plan to refuse the opportunity to tender was arrived at during a special meeting of the trustees on October 7. The meeting lasted somewhere between one and two hours while the discussion of whether to tender took approximately one-half hour. (Freese dep. at 30). Other than the trustees, John Mullan, in-house counsel for Grumman, was the only other individual present at the special meeting. John Mullan had not been formally retained by the Pension Plan as counsel. The trustees failed to consult with outside counsel, or any independent investment advisor. In part, they relied on the opinion of Dillon, Read & Co., an investment banking firm retained by Grumman to render an opinion solely on the adequacy of LTV's offering price.

The other Pension Plan trustees are Robert G. Freese and Carl A. Paladino. Approximately fifty percent of Freese's time between the announcement of the tender offer and the actual Pension Plan purchases was devoted toward raising bank credit for the purchase of Grumman common stock by Grumman. Paladino's only activity between September 23 and October 7 involved the preparation of financial material concerning Grumman Aerospace, a subsidiary of Grumman. (Paladino's dep. at pp. 13–16). He had neither formally nor informally, prior to the October 7 trustees' meeting, discussed the possibility of a Pension Plan purchase of Grumman stock. (Paladino's dep. at 24–25).

The October 7 trustees' meeting commenced with a ten-minute presentation by Mr. Mullan about ERISA, (Freese dep. at 24–25), and culminated in a unanimous vote by the trustees not to tender the Grumman shares already owned by the Pension Plan. Further discussions led to a second decision wherein they voted to purchase up to an additional 1,275,000 shares of Grumman stock. The decision not to tender was announced in a press release on October 8, the same day on which the trustees executed an amendment to the Plan's Trust Agreement providing for indemnification of the trustees by Grumman for liability arising out of any action absent willful misconduct or lack of good faith. The amendment agreement was dated October 7.

The October 7 decision to purchase Grumman stock was conditioned upon approval by the Securities and Exchange Commission of an exemption from Rule 10b–6, 17 C.F.R. § 240.10b–6, which prohibits persons interested in a "distribution" of stock from trading in that stock. The exemption was granted on October 9. Nevertheless, no purchases were made until October 12. The trustees hoped that this court would enjoin the LTV tender offer over the following weekend thereby avoiding the Pension Plan purchases at the artificially high prices created by the tender offer, or alternatively, avoiding the purchases altogether. (*See* Bierwirth dep. at 43–44). The injunction did not issue that weekend. The trustees convened briefly on October 12 and, without further discussion on the subject, decided to proceed with their purchases.

The Pension Plan purchased 958,000 shares through Dillon, Read & Co. on October 12. The price ranged from a low of $36 to a high of $39¼ at an average price of $38.61 per share. On October 13, Dillon, Read & Co. purchased an additional 200,000 shares on behalf of the Pension Plan at an average price of $36.62 per share.

The trustees offer essentially two theories of defense to the Secretary's claims. First, they believed that the Grumman stock represented a good investment for the Pension Plan. Secondly, they were concerned over the impact of an LTV takeover on the Pension Plan. The latter concern was twofold—that the Grumman Plan might be merged, terminated or otherwise altered to the detriment of its beneficiaries and that LTV's financial health, upon which its pension plans ultimately depend for contribution, was unsound.

II. DISCUSSION

In its instant motion for preliminary relief, the Secretary contends that each trustee breached his fiduciary obligation by, *inter alia*, (1) failing to act solely in the interest of the Pension Plan's participants and beneficiaries and for the exclusive purpose of providing benefits to its participants and beneficiaries and defraying reasonable expenses of plan administration, in violation of Section 404(a)(1)(A) of ERISA, 29 U.S.C. § 1104(a)(1)(A)[1] and (2) failing to act with the care, skill, prudence and diligence that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of a similar enterprise with similar objectives, in violation of Section 404(a)(1)(B) of ERISA, 29 U.S.C. § 1104(a)(1)(B).[2]

The Pension Plan is an employee benefit plan established and maintained by Grumman. The plan is an employee benefit plan within the meaning of Section 3(3) of ERISA, 29 U.S.C. § 1002(3) and therefore subject to ERISA rules and regulations pursuant to Section 4(a) of ERISA, 29 U.S.C. § 1003(a). The Secretary of Labor has standing to maintain this action under Sections 502(a)(2), (5) of ERISA, 29 U.S.C. §§ 1132(a)(2) and (5). Jurisdiction and venue in this court are proper under Sections §§ 1132(e)(1), (2).

A. *Dual Loyalties*

Each of the trustees of the Pension Plan is also an officer of Grumman or a Grumman subsidiary. John C. Bierwirth is the Chief Executive Officer and Chairman of the Board of Directors of Grumman; Robert G. Freese is a Senior Vice President and a Director of Grumman; and Carl A. Paladino is a Senior Vice President of Grumman Aerospace Corporation, a subsidiary of Grumman. Each of the trustees is a fiduciary with respect to the Pension Plan within the meaning of Section 3(21)(A) of ERISA, 29 U.S.C. § 1002(21)(A).

The alleged violations of ERISA arise from the difficult task presented to defendants during the time of the LTV tender offer of simultaneously serving two masters—Grumman and the Pension Plan. It is argued that the separate loyalties ("dual loyalties") created by their dual employment prevented the trustees from acting exclusively in the Pension Plan's interest. It is further argued that subsequent to LTV's tender offer it was *per se* unlawful for the plan's fiduciaries to act on its behalf because of their dual loyalties, without regard to whether their secondary loyalty (to Grumman) influenced their conduct. It is the latter contention which we now address.

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[1] ERISA § 404(a)(1)(A), 29 U.S.C. § 1104(a)(1)(A) provides as follows:

> Subject to sections 1103(c) and (d), 1342, and 1344 of this title, a fiduciary shall discharge his duties with respect to a plan solely in the interest of the participants and beneficiaries and—
>
> for the exclusive purpose of:
>
> (i) providing benefits to participants and their beneficiaries; and
>
> (ii) defraying reasonable expenses of administering the plan.

[2] ERISA § 404(a)(1)(B), 29 U.S.C. § 1104(a)(1)(B) provides as follows:

> Subject to sections 1103(c) and (d), 1342, and 1344 of this title, a fiduciary shall discharge his duties with respect to a plan solely in the interest of the participants and beneficiaries and—
>
> with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims.

The Secretary also contends that the trustees have violated ERISA § 406(b)(1) and (2), 29 U.S.C. § 1106(b)(1) and (2). Even assuming the trustees have committed such violations, the scope of the preliminary relief would be unaffected. Accordingly, we decline the opportunity to pass on these claims.

[1] Part 4 of Title I sets forth the fiduciary obligations which the Grumman trustees undertook to faithfully discharge. At the outset, we hold that ERISA contemplates the existence and approval, in certain circumstances, of fiduciaries acting on behalf of a pension plan even though they have dual loyalties. Section 408(c)(3) of ERISA, 29 U.S.C. § 1108(c)(3), implicitly authorizes an officer of the sponsor corporation to serve as a pension plan fiduciary by providing that Section 406 of ERISA, 29 U.S.C. § 1106 (specifying prohibited transactions), shall not be construed so as "to prohibit any fiduciary ... from serving as a fiduciary in addition to being an officer, employee agent, or other representative of a party in interest." Further, ERISA section 407, 29 U.S.C. § 1107 specifically authorizes a plan to acquire stock of the sponsoring corporation. ERISA therefore necessarily contemplates that trustees, who may be officers of the sponsoring company, may act on behalf of the pension plan in making investment decisions concerning stock of the sponsor corporation in spite of a potential conflict of interests.

A more detailed review of the statutory scheme of ERISA and its legislative history corroborates the foregoing conclusion. As previously stated, ERISA section 408(c)(3), 29 U.S.C. § 1108(c)(3), expressly contemplates fiduciaries with dual loyalties. The Conference Report on ERISA states that the statute "makes it *clear* that a party-in-interest may serve as a fiduciary in addition to being an officer ...." H.R.Conf.Rep. No. 1280, 93d Cong., 2d Sess, 312, *reprinted in* 1974 U.S.Code Cong & Ad.News 5038, 5092 (emphasis added). The Conference Report also contemplates a number of additional exceptions to the traditional rules governing fiduciary conduct. *See id.*

[2] Having provided for an unorthodox departure from the common law rule against dual loyalties, Congress provided two statutory safeguards to protect plan participants and beneficiaries. First, the statute provides that "a fiduciary shall discharge his duties with respect to a plan *solely* in the interest of the participants and beneficiaries ...." Section 404(a)(1) of ERISA, 29 U.S.C. § 1104(a)(1) (emphasis added). Therefore, although a trustee may have dual loyalties, when acting on behalf of the fund, his primary loyalty to the fund is the *only* loyalty which may affect his judgment.

[3] Mindful of the difficulty presented to trustees so situated, Congress enacted Section 406 of ERISA as a further protection for plan participants and beneficiaries. That section prohibits a fiduciary from acting in *certain specified circumstances* in order to prevent him "from being put in a position where he has dual loyalties, and, therefore, ... cannot act exclusively for the benefit of a plan's participants and beneficiaries." H.R.Conf.Rep.No.1280, *supra*, at 309, *reprinted in* 1974 U.S. Code Cong. and Ad.News at 5089. The Conference Report's concern with the dangers inherent in the case of a fiduciary with dual loyalties was expressed in connection with ERISA section 406(b)(2), 29 U.S.C. § 1106 (b)(2), which prohibits fiduciaries from acting "in any transaction involving the plan on behalf of a party (or represent a party) whose interests are *adverse* to the interests of the plan or the interests of its participants or beneficiaries." (emphasis added). If we are to interpret ERISA as incorporating a *per se* prohibition against plan fiduciaries with dual loyalties acting on behalf of the plan, then the specific prohibition enacted to prevent a fiduciary from being placed in a position of dual loyalty is completely superfluous. *See id.* The negative implication, of course, is that Congress intended that fiduciaries with dual loyalties would be per-

mitted to act in all other instances as long as they otherwise comply with ERISA section 404 and the balance of the restrictions found in ERISA section 406.

In construing ERISA, we are mindful of its remedial purposes and are therefore reluctant to depart from the inflexible, well established common law rule which precludes a fiduciary having dual loyalties from asserting the defense "that, although he had conflicting interests, he served his masters equally well or that his primary loyalty was not weakened by the pull of the secondary one." *Woods v. City National Bank & Trust Co.*, 312 U.S. 262, 269, 61 S.Ct. 493, 497, 85 L.Ed. 820 (1941), *quoted in NLRB v. Amax Coal Co.*, 453 U.S. 322, 101 S.Ct. 2789, 2794, 69 L.Ed.2d 672, *reh'g denied*, 453 U.S. 950, 102 S.Ct. 26, 69 L.Ed.2d 1036 (1981). This well established rule naturally followed from the recognition in the courts of chancery of a trustee's "unwavering duty of complete loyalty to the beneficiary of the trust, to the exclusion of the interests of all other parties." *NLRB v. Amax Coal Co.*, 453 U.S. at 329, 101 S.Ct. at 2794.

[4] Nevertheless, even at common law, trustees are allowed to trade in securities or other property of an entity with which they are affiliated as long as authorization is provided by the terms of the trust. Restatement (Second) of Trusts § 170, comment n. ("[s]uch a purchase is proper . . . if expressly or impliedly authorized by the terms of the trust"). *Accord, Central Hanover Bank & Trust Co. v. Russell*, 290 N.Y. 593, 48 N.E.2d 704 (1943) (mem.); 2 A. W. Scott, *Law of Trusts* § 170.15 at 1340-41 (3d ed. 1967). We find that Section 407 of ERISA is Congress' authorization for a trustee to invest in sponsor corporation stock in spite of dual loyalties and conflicting interests *so long as* (1) he acts exclusively for the benefit of the plan beneficiaries and participants and otherwise complies with ERISA section 404, and (2) his actions are not violative of the proscriptions of ERISA section 406. Thus, the statutory scheme has abrogated the traditional common law rule. However, bearing in mind the purposes of ERISA, we further hold that a trustee having dual loyalties has "an *especial obligation* to act fairly on behalf of those concerned with the results of the action taken." *Withers v. Teachers' Retirement System of the City of New York*, 447 F.Supp. 1248, 1256 (S.D.N.Y.1978), *aff'd mem.*, 595 F.2d 1210 (2d Cir. 1979) (applying common law principles of fiduciary duty) (emphasis added). The Grumman trustees had that very obligation when dealing with Grumman stock.

Our rejection of the Secretary's contention that the trustees' conduct was *per se* unlawful is not contrary to the Supreme Court's recent decision in *NLRB v. Amax Coal Co.* There, the Court held that the employer-selected trustees of a trust fund created under Section 302(c)(5) of the Labor Management Relations Act of 1947 ("LMRA"), 29 U.S.C. § 186(c)(5), were not employer representatives (or agents) "for the purposes of collective bargaining or the adjustment of grievances" within the meaning of Section 8(b)(1)(B) of the National Labor Relations Act, as amended by Section 101 of the LMRA. In so construing Section 8(b)(1)(B), the Court recognized that a trustee complies with his fiduciary obligations under ERISA *so long as* he refrains from engaging in specified prohibited transactions and *acts* "exclusively for the benefit of the plan's participants and beneficiaries." *See NLRB v. Amax Coal Co.*, 453 U.S. at 334, 101 S.Ct. at 2796, *quoting* H.R.Conf. Rep.No.1280, *supra*, at 296–309, *reprinted in* 1974 U.S.Code Cong. & Ad.News at 5089. In acknowledging that a trustee might possess a dual and conflicting loyalty to the appointing sponsor of the trust plan, the Court simply stated that the trustee "must overcome" that loyalty. *Id.* at 2796. Finally, the discussion of dual loyalties in the context of an employer-financed trust fund is distinguished from the instant case because ERISA's statutory scheme, unlike the LMRA, clearly contemplates the approval of fiduciaries with dual loyalties.

[5] Accordingly, we find that the trustees of the Pension Plan did not commit *per se* violations of ERISA either by their failure to abstain from the investment decision concerning Grumman stock or by the mere acquisition of Grumman stock. *See Curren v. Freitag*, 432 F.Supp. 668, 672 (S.D.Ill. 1977).

B. *Section 404(a)(1)(B) and the Prudent Man Rule*

1. *The Standard*

[6] The Secretary further argues that even if the trustees were permitted to make investment decisions (the decision to buy, sell, or hold) concerning the Grumman stock in the face of the LTV tender offer, they failed to act prudently as required by ERISA section 404(a)(1)(B). At the outset, we hold that this affirmative statutory duty—the duty to act "with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims"—subsumes the duty "to make an independent inquiry into the merits of a particular investment" decision. *See Fiduciary Standards and the Prudent Man Rule under ERISA*, 88 Harv.L.Rev. (Part 2) 960, 965 (1975).

[7] A review of a fiduciary's independent investigation is one of the well-established yardsticks against which courts have customarily tested fiduciary conduct for prudence. *See, e.g., Withers v. Teachers' Retirement System*, 447 F.Supp. at 1254–55; *In re Talbot's Estate*, 141 Cal.App.2d 309, 296 P.2d 848 (1st Dist. 1956); *In re Clark's Will*, 257 N.Y. 132, 177 N.E. 397 (1931); *In re Kent's Estate*, 146 Misc. 155, 261 N.Y.S. 698 (Sur.Ct.1932), *aff'd sub nom. In re Manufacturers Trust Co.*, 246 A.D. 604, 284 N.Y.S. 976 (1935); 3 A. W. Scott, *Law of Trusts*, § 227.1 at 1809–11. This same test is properly applied in the instant case to test defendants' conduct. *See Morrissey v. Curran*, 567 F.2d 546, 548–49 & n.9 (2d Cir. 1977).

[8] However, when a fiduciary has dual loyalties, his independent investigation into the basis for an investment decision which presents a potential conflict of interests must be both intensive and scrupulous and must be discharged with the greatest degree of care that could be expected under all the circumstances by reasonable beneficiaries and participants of the plan. Were the rule less stringent, we could not be certain that the Cardozian time-honored standard for fiduciary behavior—"the punctilio of an honor the most sensitive," *Meinhard v. Salmon*, 249 N.Y. 458, 164 N.E. 545 (1928)—would remain uncompromised. Moreover, this greater standard of care is a natural corollary to the trustee's heightened obligation to act fairly when acting with dual loyalties and is fully consistent with principles of equity and the policies underlying ERISA. *See Gilliam v. Edwards*, 492 F.Supp. 1255, 1261 (D.N.J.1980) ("To fulfill its curative aim, ERISA should be given a liberal construction to safeguard the interests of the Fund participants and beneficiaries and to preserve the integrity of Fund assets"). A thorough review of the record compels us to find that each of the trustees were woefully remiss in this regard and that the Secretary has satisfied his burden on this motion for a preliminary injunction.

2. *The Standard Applied to the Instant Case*

Defendants contend that they "gave *appropriate consideration* to the factors relevant to ERISA's standard of prudence." (Defendants' Memorandum of Law, dated October 29, 1981) (emphasis added). They argue that their decision to purchase Grumman shares was based upon their *belief* (1) that the Grumman stock presented a unique and substantial opportunity for long-term appreciation and was consistent with the portfolio needs of the Pension Plan and (2) that their decision was designed to further the purposes of the Plan and the interests of its beneficiaries.

[9] However, as indicated above, a belief, even a good faith belief, held by the trustees does not insulate them from charges that they have acted imprudently. An examination of the facts in *Withers v. Teachers' Retirement System of the City of New York*, 447 F.Supp. 1248 (S.D.N.Y.1978),

aff'd mem., 595 F.2d 1210 (2d Cir. 1979), illustrates defendants' shortfallings in acting on behalf of the Pension Plan. Even though the Teachers' Retirement System (the "TRS") was not subject to ERISA, as we have previously noted, the same fiduciary principles apply since the trustees in *Withers*, as in the instant case, were subject to common law principles of fiduciary duty. *See Marshall v. Teamsters Local 282 Pension Trust Fund*, 458 F.Supp. 986, 990 (E.D. N.Y.1978).

In *Withers*, the defendant trustees of the TRS were sued for allegedly having breached their fiduciary obligation to the TRS by authorizing the purchase of $860 million of New York City bonds during the City's financial crisis in November 1975. The bonds were highly speculative and unmarketable. Judge Conner found that the trustees had properly acted since they concluded, after a thorough independent investigation of the facts, that the long term viability of the TRS depended on the investment in New York City bonds. In finding that the trustees had fulfilled the obligation of independent investigation the court noted the following: (1) their conclusion that the bankruptcy of New York City was imminent was based on opinions from *highly reliable sources* and represented the *consensus* of a *broad spectrum* of opinion; (2) they participated in *frequent meetings* with City, State and Municipal Assistance Corporation ("MAC") officials during the summer and fall of 1975 concerning the deteriorating state of the City's finances; (3) in November 1975, there were *frequent meetings* among the trustees and the New York City Comptroller and Corporation Counsel to discuss the problems of the City's budget; (4) they acted on *all* the information available to them and "went to *great lengths* to satisfy themselves of the absence of any reasonable possibility" that investment in City bonds could be avoided, (emphasis added); (5) after concluding investment was necessary, they made every reasonable effort to "secure *maximum protection* for the beneficiaries of the TRS," (emphasis added); (6) the trustees made their decision without succumbing to the pressure exerted by both the Governor's office and by City Hall; and finally, (7) "their decision to invest in the City obligations was ... forged from *intensive independent analysis* as well as consultation with experts." (emphasis added).

For the purposes of this motion, we shall assume that the interests of the Grumman Pension Plan were identical with those of Grumman. Our inquiry is directed solely to the manner in which the trustees exercised their judgment in committing Pension Plan assets amounting to some $36,988,380 (958,000 shares at an average price of $38.61 per share) on October 12 and $7,324,000 (200,000 shares at an average price of $36.62 per share) on October 13. These purchases represented a substantial commitment of Pension Plan assets which had been estimated to be in excess of $600,000,000 at its most recent valuation.

[10] It is no defense to the Secretary's instant action that the trustees' decision to fight the LTV tender offer with Pension Plan assets might have been in the best interests of the Plan *if* their decision was arrived at without a thorough independent investigation of the basis for that decision. Luck or good fortune is no substitute for a trustee's duty of inquiry.

[11] We find that the trustees acted imprudently in purchasing Grumman stock on October 12 and 13. We further find that their conduct between the date of the LTV tender offer and mid-October evince an inability to make independent decisions on behalf of the Pension Plan solely in the interest of its participants and beneficiaries. We reach these conclusions because the trustees' decisions were made without sufficient inquiry into the facts upon which they based their decisions. We find that their conduct was solely motivated by their all-consuming desire to defeat the tender offer.

The deposition testimony of the three trustees provides overwhelming support for our conclusion. Rather than analyzing the offer, the trustees spent most of their time between September 24 and October 13 fighting the LTV tender offer. Even though it is clear that Bierwirth had, at most, a superficial understanding of the offer on September 25, he voted as a director of Grumman to reject the tender offer that same day. Our conclusion that he failed to understand the offer on the 25th is supported by his own deposition testimony. (Bierwirth dep. at 9, spent three weeks "trying to understand what the offer was . . . ."). While a reasonable inference is that Bierwirth had no interest in considering the LTV offer regardless of the potential for Grumman or the Pension Plan, Bierwirth would challenge this inference because of his "justifiable reliance" on the Dillon, Read & Co. opinion letter which was presented to the Board of Directors on September 25. We reject that contention out of hand and find that Bierwirth was committed to defeating the LTV takeover prior to the September 25 board meeting for reasons unrelated to the Dillon, Read & Co. opinion letter.

Mr. Thayer, Chairman of the Board of Directors and Chief Executive Officer of The LTV Corporation, testified subject to cross-examination by Grumman in the related case *Grumman Corp. v. The LTV Corp.*, No. CV 81-3156, that Mr. Gavin, President of Grumman and speaking on behalf of Bierwirth, prior to the tender offer, rejected LTV's offer to discuss merger prospects. The Grumman rejection came only one hour after LTV's inquiry. Bierwirth was aware of the merger proposal on September 23 and it appears that he personally rejected the offer for discussions on the subject. (*See* Bierwirth dep. at 6). The rejection came notwithstanding the assurance provided by LTV that Bierwirth would have been retained as the Chief Executive Officer of a joint Grumman-Vought Aerospace operation. Nowhere in his deposition testimony did Bierwirth indicate that he opposed the takeover because of the potential antitrust violations and the related problems of future divestiture.

Mr. Bierwirth served as Grumman's chief public spokesman in opposing the LTV takeover. He spent virtually all of his time in activities related to the takeover which included attending meetings, lobbying in Washington, D. C., appearing on talk shows and discussing the crisis with reporters. His deposition testimony fails to reveal any effort to understand how the Pension Plan, as opposed to Grumman, might have been advantaged by tendering its Grumman stock to LTV or how the fund might have been protected in the event of an LTV takeover. His inability to consider, or to request discussions, on the protection of Pension Plan benefits (and the survival of the Grumman plan as an independent plan) stemmed from his fear of a solution which would have seriously compromised his position as an advocate against the LTV takeover on behalf of Grumman. Bierwirth was totally committed to Grumman's resolution to quash the takeover bid.

In deciding as a Pension Plan trustee to reject the tender offer, Bierwirth "was quite interested in Carl Paladino's analysis of LTV . . . ," presented at the October 7 trustees' meeting. (Bierwirth dep. at p. 33). Paladino, however, was hardly a financial expert with respect to LTV. As previously mentioned, the only work performed by Paladino between September 23 and October 7 was the preparation of financial material on Grumman Aerospace. (Paladino dep. at 16). Paladino's only knowledge of LTV's financial position derived from his examination of the LTV annual report and the LTV 10-K. (Paladino dep. at 36). The trustees did not consult William Parmentier and his investment staff with regard to LTV's financial prospects. The third trustee, Mr. Freese, spent more than half of his time for the three weeks following September 25 arranging a bank line of credit for the future purchase of Grumman stock by Grumman.

Clearly, the trustees spent the abundance of their combined waking hours searching for LTV's Achille's heel and otherwise opposing the tender offer. It would be charitable to say that they "took a long and hard" look at how the takeover might damage the interests of the Pension Plan without endeavoring to make any examination of how its interests might have been advanced. Indeed, there was no real inquiry into the dangers presented to the Pension Plan in the event of a takeover. We find that their conclusions regarding the dangers presented by the takeover were based on conjecture, speculation and unfounded assumptions.

As we have previously mentioned, the trustees never considered that they might strike a deal with LTV which could have protected the Pension Plan. The following inquiry was made of Bierwirth:

> Q. Was there any consideration as to the existing Pension benefits leaving aside the gratuitous increase, any consideration to tendering subject to attempting to obtain some protection for the basic Pension benefits?

Bierwirth responded by stating one of his many unfounded assumptions:

> A. I think you would have to say that we were of the opinion that you could not protect, so we did not discuss how we could give partial protection.

(Bierwirth dep. at 29). LTV having once indicated a willingness to "talk merger" and having publicly pledged that it would not merge or terminate the Grumman Pension Plan (Bierwirth dep. at 25; Paladino dep. at 38), there was no basis for believing that LTV would have been unreceptive to discussions concerning security for Grumman Pension Plan participants and beneficiaries.

A host of other examples confirm that the trustees failed to act prudently. They failed to consult with outside, independent counsel.[3] In spite of the numerous and difficult questions presented by the LTV tender offer, we must reiterate that the October 7 meeting lasted less than two hours with only one-half hour devoted to the decision to reject the offer. The decision not to tender, and thereafter, to purchase, was arrived at without the consultation of an independent investment advisor. Yet, Pension assets were expended with the knowledge that if the trustees' objectives were realized, the Pension Plan would have to absorb substantial short-term losses.[4]

Defendants contend that independent investment advice was unnecessary since the Plan historically handled investment matters in-house. However, the in-house investment staff was not consulted. Viewing the October 12 and 13 purchases from solely an investment standpoint, *i.e.*, ignoring the alleged impact on the Plan in the event of a takeover, taking notice of the availability in the marketplace of other investments, and considering that Grumman stock was selling at an all time high, the trustees also should have considered the long-term appreciation offered by other stocks with the advice of an investment counselor. It is axiomatic to state that any given investment is sensible only if it is superior to other investments available in the marketplace.

The trustees contend that they had guidance from reliable investment advisors. They cite the July 1981 Lehman Brothers Kuhn Loeb ("Lehman Brothers") research report which recommended the purchase of Grumman common stock to LTV. The report, however, did not render an opinion on the market value of the Grumman stock and the recommendation was made at a time when Grumman stock was trading at $28 per share. The Lehman Brothers' report was hardly support for the proposition that Grumman stock was worth $45 per share to any investor. The tender offer price naturally included a premium for majority control over Grumman as was evidenced by LTV's condition of purchase (the acquisition of at least 50.01% of Grumman common stock on a fully-diluted basis). In contrast, the Pension Plan did not seek control. Without further analysis, it is evident that the Lehman Brothers' recommendation, prepared with LTV's unique financial position and business objectives in mind, was inadequate support for the trustees' decision to purchase Grumman stock at $45 per share.

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[3] The only counsel available at the October 7 trustees' meeting was John Mullan, in-house counsel to Grumman. The propriety of consulting Grumman's counsel under such circumstances is subject to serious question.

[4] Following the affirmance by the Second Circuit Court of Appeals of our decision enjoining the LTV tender offer, *Grumman v. The LTV Corp.*, 665 F.2d 10 (2d Cir. 1981), the Pension Plan paper losses exceeded $10 million.

Likewise, the trustees were not justified in relying on the Dillon, Read & Co. opinion prepared for the Grumman Board of Directors, dated September 25, 1981. The opinion letter drafted for the Board expressly noted that Dillon, Read & Co. had "provided investment banking services to Grumman in the past, including acting as a manager of an offering of its convertible subordinated debentures in April, 1980." Dillon, Read & Co. had an obvious interest in Grumman's continuing independence, and therefore, as horn book law indicates, its opinion should have been subject to some level of scrutiny:

> In reaching his conclusion [concerning an investment decision, a trustee] may take into consideration advice given to him by attorneys, bankers, brokers and others whom prudent men in the community regard as qualified to give advice. He is not justified, however, in relying wholly upon the advice of others, since it is his duty to exercise his own judgment in the light of the information and advice which he receives. In relying upon the advice of another, he should consider whether the person giving the advice is disinterested. Thus it has been held that in purchasing securities for the trust he is not justified in relying solely on the advice of a broker interested in the sale of the securities.

3 A. W. Scott, *Law of Trusts*, § 227.1 at 1809. The two-page opinion letter was reviewed by the Pension Plan trustees at the October 7 meeting.[5] The letter was unaccompanied by any underlying financial statistics and no representative from Dillon, Read & Co. was present for questioning. Nevertheless, the trustees relied on a report literally prepared overnight and based on the limited amount of information available at the time of the report's preparation. It was gross negligence, if not bad faith, to rely on such a report prepared some twelve days prior to the October 7 meeting *without any effort* to have Dillon, Read & Co. update their evaluation of LTV's offer.[6]

In connection with the foregoing, the balance of pertinent facts surrounding the trustees' decision compel us to conclude that they in fact proceeded in bad faith. Between the time of the tender offer and the October Pension Plan purchases, they had one goal—to defeat the tender offer. Their policy was one of "conscious avoidance"; they intentionally avoided any inquiries which might have indicated that the success of LTV's tender offer could have been favorable to the Pension Plan.

The trustees had been educated on the complexities of "what goes on in the world of takeovers." (Bierwirth dep. at 7). Earlier in 1981, Grumman had retained the firm of Skadden, Arps, Slate, Meagher & Flom ("Skadden, Arps") to render such advice. By retaining Skadden, Arps, the Grumman board manifested an understanding of the need to have expert legal advice on matters involving intricate federal statutes and administrative regulations. Each of the trustees were, and are, sophisticated businessmen. Yet, after having been shown pertinent sections of ERISA by Mr. Mullan at the October 7 meeting and after a brief oral presentation concerning the obligations of plan fiduciaries under ERISA, the trustees had no questions. (Paladino dep. at 30; Freese dep. at 24–25). Their lack of concern or curiosity about the intricacies of ERISA and how it might affect the Pension Plan's ability to respond to the tender offer is in sharp contrast to the forward thinking decision of the Grumman directors, including Bierwirth and Freese, in retaining Skadden, Arps for general advice on corporate takeovers. The failure to retain counsel with an expertise in the area of ERISA during the four day period between the October 7 meeting and the massive buying campaign commencing on October 12 is strong evidence of their desire to *avoid* advice that might counsel against pension plan purchases. There was ample time to seek advice and it was no coincidence that the trustees failed to do so. Finally, their execution of the Trust Agreement Amendment dated October 7, 1981 which "clarified" the Pension Plan trustees' right to indemnification (Paladino dep. at 67; exhibit 2), is a further indication of their awareness of ERISA's intricacies and the need for legal advice on matters related to the Pension Plan defense of the LTV takeover.

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[5] The two-page opinion letter authored by Dillon, Read & Co. upon which defendants so heavily relied was not submitted in opposition to the Secretary's motion until the court, *sua sponte*, made a request to defendants' counsel for its production on November 23, 1981.

[6] We also agree with the Secretary that no reliance could be placed upon the press release announcing the New York State Comptroller's decision not to tender the 60,000 Grumman shares held by the state pension plan.

The trustees ignored other inquiries which should have been made. Plan fiduciaries have an affirmative duty to "[defray] reasonable expenses of administering the plan." Section 404(a)(1)(A)(ii) of ERISA, 29 U.S.C. § 1104(a)(1)(A)(ii). Nevertheless, Paladino and Freese had no knowledge as to whether Dillon, Read & Co. was paid a brokerage commission for executing the October 12 and 13 purchase transactions. (Freese dep. at 41; Paladino dep. at 56). While Bierwirth knew that Dillon, Read & Co. was paid seven and a half cents a share, he had no idea whether that commission ($86,850 in total) was standard. (Bierwirth dep. at 56–57).

Even assuming, as the trustees contend, that they were entitled to consider the impact on the Pension Plan of a successful LTV tender offer, we decline to detail their lack of prudence in this regard, except as is evident from the following: (1) none of the trustees knew how many pension plans were sponsored by LTV; (2) no effort was made to learn anything about LTV's pension plans; further, Bierwirth and Freese never considered examining the Internal Revenue Service Form 5500 annual report which all pension plans file even though they were aware that such reports are filed; (3) though much was made of the $225 million unfunded pension liability assumed in connection with the LTV acquisition of the Lykes Corporation, the trustees neither knew nor investigated why, when or how it came about; Mr. Freese suspected that the unfunded pension liability was not attributable to LTV mismanagement; and finally (4) though they claim they were fearful that LTV would merge or terminate the Pension Plan (a) Bierwirth and Freese were aware of public pledges from LTV to the contrary but took no steps to secure such assurances and (b) Paladino admitted no basis for believing that LTV would terminate the Pension Plan.

The conduct of the trustees reflects a silent agreement among them (1) to "see, hear, and speak" nothing positive about the LTV tender offer and avoid any inquiries which might have uncovered facts to the contrary and (2) to isolate themselves from legal advice which might have precluded the Pension Plan from participating in the well orchestrated plan to kill the LTV takeover. The unavoidable conclusion is that the trustees failed to discharge their duty of prudence either diligently or in good faith.

III. PRELIMINARY RELIEF

[12] The statutory provisions of ERISA authorize the court to award the relief it deems appropriate upon finding that a fiduciary has breached responsibilities, obligations or duties arising under the statute. In pertinent part, ERISA section 409(a), 29 U.S.C. § 1109(a) provides:

> Any person who is a fiduciary with respect to a plan who breaches any of the responsibilities, obligations, or duties imposed upon fiduciaries by this subchapter shall be personally liable to make good to such plan any losses to the plan resulting from each such breach, and to restore to such plan any profits of such fiduciary which may have been made through use of assets of the plan by the fiduciary, and shall be subject to such other equitable or remedial relief as the court may deem appropriate, including removal of such fiduciary....

We find that further proceedings are required in order to fashion the relief which will most suitably promote the interests of the Pension Plan, its participants and its beneficiaries.

The relief requested by the Secretary is the appointment of a receiver *pendente lite* who can independently assess the desirability of disposing or holding the Grumman stock held by the Pension Plan. The Secretary does not object to the continuing service by defendant trustees, *pendente lite*, in all matters except as to the Grumman stock. The identical request for preliminary relief has been made in a related case, *Lawrence v. Grumman Corporation Pension Plan*, No. CV 81-3530, not yet consolidated with this action.

Plaintiff has shown a likelihood of success on his claim that each of the trustees has acted imprudently with respect to their recent investment decisions concerning Grumman stock. They have manifested an inability to separate their corporate loyalty and their loyalty to the Pension Plan. The manner in which they exercised their judgment with respect to the Grumman stock was so egregiously imprudent that we must infer a likelihood of further violations. The very decision to hold Grumman stock makes Grumman a less likely candidate as a takeover target. The conduct of the Pension Plan trustees has demonstrated the difficulty that they have in examining objectively an investment decision which might affect the independence of Grumman.

[13] While it is clear that interim relief pursuant to ERISA section 409 is in order, we are reluctant to fashion such relief without comment from all interested parties. We would consider a number of factors for the purposes of selecting an interim remedy including: "(1) the purposes of the trust; (2) the relative pecuniary advantages to the trust estate of the various remedies; (3) the nature of the interest of each beneficiary; (4) the practical availability of the various remedies; and (5) the extent of the deviation from the terms of the trust required by the adoption of each of the remedies." *Eaves v. Penn*, 587 F.2d 453, 462-63 (10th Cir. 1978), *quoting* Restatement (Second) of Trusts § 214 comment D.

[14] Accordingly, the parties, including the interested parties in the action entitled *Lawrence v. Grumman Corporation Pension Plan*, No. CV 81-3530, as well as any participants and beneficiaries who so desire, are directed to submit recommendations and arguments for the appropriate type of relief on or before December 18, 1981. Until such time as this court fashions further preliminary relief following the aforementioned submission date, John C. Bierwirth, Robert G. Freese and Carl A. Paladino, in their capacity as trustees of the Grumman Corporation Pension Plan, are hereby restrained from buying, selling or exercising any powers, rights or other duties on behalf of said Plan respecting stock or other securities issued by the Grumman Corporation except upon the written consent of the Secretary of Labor, and it is

SO ORDERED.

Charles W. LEIGH and Ervin F. Dusek, etc., Plaintiffs-Appellants,

and

George Johnson, et al., Intervening Plaintiffs-Appellants,

v.

Clyde William ENGLE, et al., Defendants-Appellees.

No. 82-2943, 82-3040.

United States Court of Appeals,
Seventh Circuit.

Argued June 6, 1983.

Decided Jan. 27, 1984.

As Modified On Denial of Rehearing and Rehearing In Banc
March 20, 1984.

Beneficiaries of employee benefit plan brought action against plan administrators and others for alleged violations of fiduciary duties under ERISA. The United States District Court for the Northern District of Illinois, George N. Leighton, J., entered judgment for defendants, and beneficiaries appealed. The Court of Appeals, Cudahy, Circuit Judge, held that: (1) trust administrators did not act solely in interests of plan beneficiaries, where they invested trust assets in companies involved in corporate control contests, administrators themselves were actively involved in the control contests and had substantial interests in them, administrators failed to make intensive and independent investigation of the investment options open to the trust, and trust's investment decision never deviated from best interests of outside investment group; (2) mere fact that trust lost no money in the challenged investment transactions did not preclude ERISA cause of action; (3) corporate director and parent corporation were ERISA plan fiduciaries to extent they selected and retained plan administrators and had fiduciary duty to oversee administrators' investment decisions; (4) District Court would be required to determine on remand whether delay in distribution of trust assets after its legal termination was reasonable and whether it injured plan beneficiaries; (5) fiduciaries who benefitted from improper use of trust assets had burden of showing which profits were attributable to their own investments apart from their control of the trust assets; and (6) awards of attorney fees and costs to defendants would be reversed.

Vacated and remanded.

1. Master and Servant ⟹78.1(7)

Mere fact that ERISA profit-sharing trust lost no money in challenged investment transactions but, in fact, received extraordinary return on the investment, did not preclude cause of action against trustees and other defendants for breach of fiduciary duty in improperly risking trust assets at least in part to enhance other defendants' control position with respect to corporations in which the investments were made. Employee Retirement Income Security Act of 1974, § 409(a), as amended, 29 U.S.C.A. § 1109(a).

2. Federal Courts ⇐754

Though district court's findings of fact must be accepted unless they are found to be clearly erroneous, where findings of fact are actually mixed findings of fact and law, review is consequently less deferential than it might otherwise be. Fed.Rules Civ. Proc.Rule 52(a), 28 U.S.C.A.

3. Master and Servant ⇐78.1(7)

Good faith is not a defense to an ERISA fiduciary's breach of duty of loyalty. Employee Retirement Income Security Act of 1974, §§ 404(a), 406, as amended, 29 U.S.C.A. §§ 1104(a), 1106.

4. Master and Servant ⇐78.1(7)

Evidence established that ERISA profit-sharing plan administrators did not act solely in interests of plan beneficiaries where they invested plan assets in companies involved in corporate control contests, administrators themselves were actively engaged in the control contests and had substantial interests in them, administrators failed to make intensive and independent investigation of investment options open to the plan, and investment decisions never deviated from best interests of outside investment group. Employee Retirement Income Security Act of 1974, §§ 404, 404(a)(1)(B), 406, as amended, 29 U.S.C.A. §§ 1104, 1104(a)(1)(B), 1106.

5. Master and Servant ⇐78.1(7)

Protective prohibited transaction ERISA provisions relating to plan fiduciary standards should be read broadly in light of Congress' concern with welfare of plan beneficiaries, and courts should look carefully at transaction to decide whether plan assets were used by or for the benefit of a party in interest or whether fiduciary dealt with plan assets in his own interest. Employee Retirement Income Security Act of 1974, §§ 404, 406, 406(a)(1)(D), (b)(1), as amended, 29 U.S.C.A. §§ 1104, 1106, 1106(a)(1)(D), (b)(1).

6. Master and Servant ⇐78.1(7)

Protective prohibited transaction ERISA provisions relating to fiduciary standards cover actions of trustee who buys shares in target corporation in order to assist either the target's management or the raider in its quest for corporate control or control premium. Employee Retirement Income Security Act of 1974, §§ 404(a)(1), 406(a)(1)(D), (b)(1), as amended, 29 U.S.C.A. §§ 1104(a)(1), 1106(a)(1)(D), (b)(1).

7. Master and Servant ⇐78.1(7)

It is not per se impermissible for employee benefit plans to invest in companies involved in control contests or to ally themselves with one side or another in a control contest; central issue is independence of plan fiduciaries who must always be able to act solely for benefit of those whose funds are entrusted to them. Employee Retirement Income Security Act of 1974, §§ 404(a)(1), 406(a)(1)(D), (b)(1), as amended, 29 U.S.C.A. §§ 1104(a)(1), 1106(a)(1)(D), (b)(1).

8. Master and Servant ⇐78.1(7)

ERISA ties fiduciary responsibilities to a person's actual authority. Employee Retirement Income Security Act of 1974, § 3(21)(A), as amended, 29 U.S.C.A. § 1002(21)(A).

9. Master and Servant ⇐78.1(7)

Corporate director and parent corporation were ERISA plan fiduciaries to extent that they performed fiduciary functions in selecting and retaining plan administrators, and, at least where plan administrators selected were close business associates of director, were required to act with appropriate prudence and reasonableness in overseeing administrators' management plan assets. Employee Retirement Income Security Act of 1974, §§ 3(21)(A), 404(a)(1), 405(a, c), as amended, 29 U.S.C.A. §§ 1002(21)(A), 1104(a)(1), 1105(a, c).

10. Master and Servant ⇐78.1(7)

In determining whether administrators' delays in distributing funds in ERISA-controlled profit sharing fund after corporation's bankruptcy were reasonable and did not injure plan beneficiaries, District Court was required to consider several relevant factors, including administrators' conflicts of interest. Employee Retirement Income Security Act of 1974, §§ 404, 404(a)(1)(B), as amended, 29 U.S.C.A. §§ 1104, 1104(a)(1)(B).

11. Master and Servant ⇐78.1(7)

ERISA provision relating to fiduciary liability for breach of any responsibility, obligation, or duty imposed upon such fiduciary permits recovery of fiduciary's profits only where there is causal connection between use of plan assets and profits made by the fiduciary on investment of his own assets. Employee Retirement Income Security Act of 1974, §§ 409, 409(a), as amended, 29 U.S.C.A. §§ 1109, 1109(a).

12. Trusts 🔑**372(1)**

In suit against a trustee who has commingled trust assets with his or her own so that it is difficult to discern which property and profits belong to whom, trustee has burden of showing which property and profits are his; trustee is responsible both for the difficulty and for resolving it.

13. Master and Servant 🔑**78.1(7)**

Profit-sharing trust fiduciaries who benefitted from improper use of trust assets had burden of showing which profits were attributable to their own investments apart from their control of the trust assets. Employee Retirement Income Security Act of 1974, § 409(a), as amended, 29 U.S.C.A. § 1109(a).

14. Master and Servant 🔑**78.1(8)**

Even where ERISA plaintiff does not prevail on his or her claim, award of attorney fees against plaintiff will rarely be justified. Employee Retirement Income Security Act of 1974, § 502(g)(1), as amended, 29 U.S.C.A. § 1132(g)(1).

15. Federal Courts 🔑**933**

Given rulings on appeal by profit-sharing trust beneficiaries that trust administrators violated their fiduciary duties to administer the trust solely in interest of the beneficiaries and that other individuals and entities were ERISA fiduciaries, with extent of liability to be determined on remand, attorney fee awards in favor of the administrators and other fiduciaries would be reversed. Employee Retirement Income Security Act of 1974, § 502(g)(1), as amended, 29 U.S.C.A. § 1132(g)(1).

Ware Adams, Chicago, Ill., David P. List, Eugene A. Schoon, James R. Stinson, Sidley & Austin, of counsel, Chicago, Ill., for plaintiffs-appellants.

Richard C. Moenning, Chicago, Ill., for intervening plaintiffs-appellants.

Morton Denlow, Sachnoff, Weaver & Rubenstein, Ltd., Chicago, Ill., for defendants-appellees.

Francis X. Lilly, Deputy Solicitor, Robert N. Eccles, Acting Associate Solicitor, Norman P. Goldberg, Counsel for Fiduciary Litigation, Marc I. Machiz, Asst. Counsel, Thomas L. Holzman, Atty., U.S. Dept. of Labor, Washington, D.C., amicus curiae.

Before WOOD and CUDAHY, Circuit Judges, and GRANT, Senior District Judge.*

CUDAHY, Circuit Judge.

Plaintiffs in this case are beneficiaries of an employee benefit plan who alleged that the plan administrators and others had violated fiduciary duty provisions of the Employee Retirement Income Security Act of 1974, 29 U.S.C. §§ 1001–1461 ("ERISA"). The heart of the case is a dispute over how ERISA governs the actions of plan administrators and other fiduciaries with respect to investment activities in contests for corporate control. The beneficiaries allege that the plan administrators and other defendants violated ERISA when they used plan assets to purchase stocks of companies that were targets of the defendants' investment program. After a bench trial, the district court entered judgment for the defendants. We vacate and remand.

I.

Plaintiffs-appellants are beneficiaries of the Reliable Manufacturing Corporation Employees Profit Sharing Trust ("Reliable Trust"). This action was originally filed by Charles W. Leigh and Ervin F. Dusek; they are beneficiaries of the Reliable Trust and former owners of the Reliable Manufacturing Corporation ("Reliable Manufacturing"). Intervening plaintiffs are a class of all other Reliable Trust beneficiaries who have fully vested rights in the trust.

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* Honorable Robert A. Grant, Senior District Judge for the Northern District of Indiana, is sitting by designation.

The Reliable Trust was created by Reliable Manufacturing in 1968 as an employees' profit sharing trust; the trust administrators were appointed by the Reliable Manufacturing board of directors. The Reliable Trust is subject to ERISA, and plaintiffs allege that the defendants-appellees violated their fiduciary duties under ERISA in a series of investments the Reliable Trust made in the spring of 1978. Until March 1978, the trust held all of its assets in the form of fixed income money market investments. In late March 1978, the trust invested approximately 30% of its assets in the stock of three companies: Berkeley Bio Medical, Inc. ("Berkeley"), Outdoor Sports Industries, Inc. ("OSI"), and the Hickory Furniture Company ("Hickory"). Both before and after the trust's purchases, other defendants made sizable investments in the same companies. Plaintiffs allege that the investment of approximately 30% of the Reliable Trust's assets in these three companies was done to aid the defendants who hoped either to win control of the companies or to earn substantial "control premiums."

Defendants-appellees are a group of individuals and business entities with close connections to defendant Clyde W. Engle. The complex network of legal and financial relationships among the defendants is central to our disposition of this case, so we must trace them in some detail. Although defendants dispute the characterization, we will on occasion refer to them as the "Engle group."

A.

Clyde Engle stands at the center of the network. He is an Illinois financier and investor with numerous business interests.[1] Since 1976 Engle has been chairman of defendant Libco Corporation. In the spring of 1978, Engle owned 31.5% of Libco shares and through trusts for his children controlled an additional 6.4% of Libco. Supplemental Appendix at 496. He also had some degree of control over an additional 12% of Libco shares owned by the Sierra Capital Group, described below. Clyde Engle's offices are at Suite 1600, 625 North Michigan Avenue, Chicago, Illinois.

Defendant Libco Corporation is a holding company which purchased 100% of the common stock of Reliable Manufacturing from plaintiffs Leigh and Dusek in April 1977.[2] Libco also has offices at Suite 1600, 625 North Michigan Avenue in Chicago. In the spring of 1978, Libco owned 64% of the stock of defendant Telco Marketing Services, Inc. ("Telco"). At that time, Clyde Engle was chairman of the board, chief executive officer and treasurer of Telco. Telco's offices are also at Suite 1600, 625 North Michigan Avenue in Chicago.

Defendant Telvest, Inc. ("Telvest") is a wholly owned subsidiary of Telco formed on June 1, 1978, for investment purposes. Engle was president, treasurer and a director of Telvest in 1978. Telvest's offices are also located at Suite 1600, 625 North Michigan Avenue in Chicago.

Two other Engle businesses are not parties to this lawsuit, but their investments in Berkeley, OSI and Hickory in 1978 are relevant to the dispute here. First, GSC Enterprises, Inc. ("GSC") is a holding company which owns the Bank of Lincolnwood. In 1978 Engle was chairman of the board and president of GSC, as well as chairman of the board of the bank. GSC's offices are also located at Suite 1600, 625 North Michigan Avenue, Chicago. Second, the Sierra Capital Group ("Sierra") is an Illinois limited partnership engaged in investment activities. The general partner in Sierra is Sierra Associates, another Illinois limited partnership. Clyde Engle is one of two general partners of Sierra Associates. In the spring of 1978, among its other investments, Sierra owned 12% of Libco stock and 19% of GSC stock. Sierra's offices are also at Suite 1600, 625 North Michigan Avenue in Chicago.

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[1] Other business activities of Engle and other defendants are described in several reported federal decisions. *See, e.g., Telvest, Inc. v. Bradshaw*, 697 F.2d 576 (4th Cir.1983); *Issen v. GSC Enterprises, Inc.*, 508 F.Supp. 1278 (N.D. Ill.1981); *Telvest, Inc. v. Wisconsin Real Estate Investment Trust*, 489 F.Supp. 250 (E.D.Wis. 1980); *Securities and Exchange Comm'n v. GSC Enterprises, Inc.*, 469 F.Supp. 907 (N.D.Ill. 1979). The investments in this case have also spawned other litigation. *See, e.g., Outdoor Sports Industries, Inc. v. Telvest, Inc.*, 88 F.R.D. 44 (N.D.Ill.1980); *Libco Corp. v. Adams*, 100 Ill.App.3d 314, 55 Ill.Dec. 805, 426 N.E.2d 1130 (1981) (defamation suit against plaintiffs' attorney in this case).

[2] Reliable Manufacturing went into involuntary bankruptcy proceedings in March 1979 and was declared bankrupt on December 6, 1979. The sale of Reliable Manufacturing and the subsequent bankruptcy proceedings are described in *In re Reliable Manufacturing Corp.*, 703 F.2d 996, 998-99 (7th Cir.1983).

Defendant Nathaniel Dardick is an attorney who played key roles in all of the organizations described above. Dardick graduated from the University of Chicago Law School in 1974. He was associated for several years with the Chicago firm of Sachnoff Schrager Jones Weaver & Rubenstein, which did work for Clyde Engle.[3] He then established his own firm with offices at Suite 1600, 625 North Michigan Avenue in Chicago. During 1978 and 1979, Dardick was retained as personal counsel to Clyde Engle. He was also general counsel to Libco, Telco, Telvest, GSC, the Bank of Lincolnwood and Sierra. The record does not show clearly whether Dardick had other clients in 1978 and 1979, but it is clear that Engle and these organizations accounted for most of Dardick's income from his law practice.[4] Dardick is also one of two administrators of the Reliable Trust, and he had direct control over the trust's investments in 1978 and 1979.

Defendant Ronald Zuckerman was president of Reliable Manufacturing and a member of the Reliable Manufacturing board of directors in 1977 and 1978. However, he received no salary from Reliable Manufacturing. He was paid only as a member of the Libco board and as an investment consultant to Libco. Zuckerman was also the other administrator of the Reliable Trust. He and Dardick were appointed administrators in September 1977 by the Reliable Manufacturing board of directors, composed of Engle, George Contarsy and Zuckerman himself. (Engle, Contarsy and Zuckerman were also directors of Libco.) Neither Dardick nor Zuckerman received compensation as trust administrators. Zuckerman's offices are also at Suite 1600, 625 North Michigan Avenue in Chicago.

Charles Newbill was originally named as a defendant in the case, but he was never served with the complaint. His role in the case is central, for he was the investment analyst who identified the investment opportunities for Dardick and the Reliable Trust, as well as for Engle, Libco, Telco, Telvest, Sierra and GSC. Newbill first met Engle when both worked at the Harris Bank in Chicago. Newbill was also a general partner in Sierra Associates between 1970 and 1972, and he worked abroad briefly. Newbill went to work for Libco and Engle as an investment consultant in 1976. During 1977 and part of 1978, Libco was Newbill's only paying client.[5] According to Newbill's testimony, he sought financial information from several thousand companies, analyzed their replies to look for undervalued companies, and identified thirty companies which he thought had good investment potential for Libco. During the early months of 1978, Newbill talked with both Engle and Dardick about his research, and he narrowed the list of investment targets. To both Engle and Dardick, he recommended investments in Berkeley Bio Medical, Inc. ("Berkeley"), Hickory Furniture Company ("Hickory"), and Outdoor Sports Industries, Inc. ("OSI"). Newbill's office was also at Suite 1600, 625 North Michigan Avenue in Chicago.

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[3] The firm of Sachnoff Weaver & Rubenstein has represented all defendants in this lawsuit at trial and on appeal.

[4] *See* Supplemental Appendix at 294–304.

[5] Newbill submitted a bill to the Reliable Trust for investment advice given in early 1978, but the bill was not prepared until December 1978, several months after this litigation was filed to challenge the investments Newbill recommended. To the extent that Newbill provided investment counseling to the Reliable Trust, he may be considered a fiduciary of the trust. *See* 29 U.S.C. § 1002(21)(A)(ii).

Defendant National Boulevard Bank is now trustee of the Reliable Trust. The bank became trustee on February 5, 1979, after the challenged investments were made but while the trust still held its shares of OSI and Hickory. The bank is a defendant because all plaintiffs seek an immediate distribution of the assets remaining in the trust.

B.

Plaintiffs' claim here depends upon the relationships between the Reliable Trust's investments in Berkeley, OSI and Hickory, and the activities of other members of the Engle group. Therefore we must examine the activities in considerable detail.

The Engle group's investment and acquisition plans for Berkeley, Hickory and OSI appear in the records of a meeting of the Telco board of directors on April 21, 1978. Supplemental Appendix at 424–29. The meeting was held at Suite 1600, 625 North Michigan Avenue in Chicago. Engle chaired the meeting and Dardick acted as secretary.[6] Engle informed the board that Telco had approximately $2,000,000 available for investment, and he recommended that Telco invest the money in up to 10% of the outstanding shares of Berkeley, Hickory and OSI. Newbill presented to the board his analysis of the three companies. The minutes of the meeting show that the Telco board learned that members of the group had already begun to establish positions in each of the three companies:

> As part of these discussions, the Board was also advised of the ownership positions in such companies of certain affiliates of the Company and associates of certain directors of the Company, namely Libco Corporation, GSC Enterprises, Inc., Clyde Wm. Engle, Sierra Capital Group, Ronald K. Zuckerman *and the Reliable Manufacturing Corporation Employees' Profit Sharing Trust.* In particular, it was disclosed that the following persons own shares of Berkeley, Hickory and OSI in the amounts set opposite their respective names as follows:

	Berkeley	Hickory	OSI
Libco Corporation		47,000	
Clyde Wm. Engle	41,670		3,500
GSC Enterprises, Inc.	32,100	4,000	8,000
Ronald K. Zuckerman	1,200		
Sierra Capital Group	21,600		
Reliable Profit-Sharing Trust	*15,000*	*8,000*	*12,500*

Supplemental Appendix at 426 (emphasis supplied). At the time of the April 21st meeting, the various members of the Engle group, including Telco,[7] owned approximately 5.58% of outstanding Berkeley shares, 2.98% of outstanding OSI shares and 4.88% of outstanding Hickory shares. Short Appendix at 29–33. The Telco board adopted a resolution authorizing management to purchase approximately 10% of the outstanding shares of the three companies, but the resolution also put ceiling prices on the purchases. The resolution authorized Telco to consolidate the group's holdings by purchasing shares owned by Sierra, Engle, Libco and GSC. Supplemental Appendix at 427. After the April 21st meeting, virtually all of the group's further purchases of the three stocks were made by Telco or by its subsidiary, Telvest, formed in June 1978.

Thus, during 1978 when the Reliable Trust invested 30% of its assets in Berkeley, OSI and Hickory, other members of the Engle group were purchasing substantial amounts of stock in the three companies both before and after the trust purchases.[8] Plaintiffs contend that the Engle group purchases and the trust's purchases were part of a concerted investment and acquisition program by Engle and his associates.

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[6] Zuckerman did not attend the meeting.

[7] Telco began to purchase Berkeley and OSI shares on April 17, 1978.

[8] The appellants have not pressed in this court their claims regarding trust investments in other securities, including Bank of Lincolnwood capital notes and Joseph Dixon Crucible Company common stock. Therefore, we have not considered the district court's findings with respect to those investments.

They allege that the trust's assets were invested to enhance the Engle group's position with respect to control of the three target companies.

There is no claim here that the Reliable Trust lost any money through the disputed investments. Indeed, the trust profited handsomely from its investments in Berkeley and OSI.[9] Instead, plaintiffs here claim that the trust's assets were put at risk to benefit the Engle group in its program of acquisitions.[10]

1. *Berkeley investments:* The Engle group's interest in Berkeley began in early 1978, when Berkeley was the target of an unfriendly takeover attempt by Cooper Laboratories, Inc. ("Cooper"). Berkeley president Irving Abramowitz asked Engle to help him defend against the takeover, and Engle purchased more than 60,000 shares of Berkeley stock for himself and GSC in January 1978. By the beginning of March, Sierra and Zuckerman had also purchased Berkeley shares, and the holdings of Engle, GSC, Sierra and Zuckerman amounted to approximately 3.6% of Berkeley shares.

In late February, Engle learned that Abramowitz and Cooper were planning a deal to settle their control contest. Berkeley management planned to give Cooper control of Berkeley's medical equipment subsidiary in return for Cooper's shares of Berkeley. The deal would have kept Abramowitz in control of Berkeley. Engle thought the proposed deal would be disadvantageous to minority shareholders such as himself. Supplemental Appendix at 554–61. Plaintiffs contend that Engle was "locked in" as a minority shareholder under hostile management, and that he sought to escape his position by increasing his control of the company. Engle bought an additional 11,200 shares of Berkeley for himself and GSC between February 27th and March 10th.

Between March 17, 1978, and March 31, 1978, the Reliable Trust bought at Dardick's direction 15,800 shares of Berkeley stock at a total cost of $71,580.53. Those 15,800 shares represented approximately 10% of the trust's assets at the time and constituted 0.65% of the outstanding Berkeley shares. Adding the trust's shares to those owned by Engle, Zuckerman, GSC and Sierra, the group owned a total of 4.65% of Berkeley at the end of March 1978.

While the Reliable Trust was buying Berkeley shares on his orders, Dardick was helping Engle respond to the proposed deal between Berkeley and Cooper. On March 22, 1978, Engle sent letters on GSC letterhead to the Berkeley outside directors protesting the proposed deal and arguing that it was contrary to the interests of minority shareholders. He described the transaction as an "improper sweetheart deal." The letters suggested that Engle would take further steps if necessary to protect the interests of minority shareholders. Dardick helped Engle prepare these letters and actually signed Engle's name to them. About two weeks later, Engle, Sierra and GSC

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[9] The Reliable Trust's investments in Berkeley, OSI and Hickory may be summarized as follows:

	Number of Shares	Purchase Price	Sale Price	Profits	Return on Investment
Berkeley	15,800	$ 71,580.53	$118,500.00	$ 46,919.47	66%
OSI	12,500	77,736.83	187,500.00	109,763.17	141%
Hickory	12,000	72,433.21	75,000.00	2,566.79	4%
Totals		$221,750.57	$381,000.00	$159,249.43	72%

Profits and return on investment do not include dividends received.

[10] It is not clear whether the Engle group intended to acquire majority control of Berkeley, OSI or Hickory. The group eventually acquired a majority of Hickory stock, but Hickory management did not oppose the acquisition. Both Berkeley and OSI management resisted the Engle group's acquisition efforts, and the Engle group succeeded in acquiring only 10.7% and 22% of the two companies respectively. The Reliable Trust made substantial profits on its Berkeley and OSI investments, yet made

filed suit to enjoin consummation of the deal between Berkeley and Cooper.[11] Dardick acted as their attorney in the suit. Thus, at the same time Dardick was investing 10% of the Reliable Trust's assets in Berkeley stock, he and Engle were arguing that Berkeley management was acting contrary to the interests of minority shareholders such as the Reliable Trust.

In April Telco began to purchase Berkeley shares, and by August the Engle group owned 10.72% of Berkeley stock. The litigation initiated by Engle and his associates to enjoin the Berkeley-Cooper deal was settled in August 1978 by having Cooper buy the Berkeley shares controlled by the Engle group for a very profitable price. The Reliable Trust was not a party to the lawsuit, nor were trust funds used in the litigation. However, the trust's shares were included in the settlement.[12]

2. *OSI investments:* In March 1978, the Reliable Trust and GSC began purchasing OSI stock. By the end of March, the trust owned 12,400 shares and GSC owned 5,100 shares, totalling 1.22% of the outstanding OSI shares. The trust had spent $77,736.83 for its shares of OSI. At the time of the April 21st Telco board meeting, GSC, Engle, Telco and the Reliable Trust owned 42,800 shares of OSI, or approximately 2.98% of the outstanding shares. Telco and later Telvest continued to purchase OSI stock steadily until March 1979, when the group's holdings were 312,400 shares, or 21.73% of outstanding shares. On May 3, 1978, Engle and Newbill visited OSI management and asked that Engle be put on the OSI board, but the proposal was rejected. A few days later, Telco and Libco filed with the Securities and Exchange Commission a Schedule 13D revealing the Engle group's purchases of OSI stock and their intentions to acquire more shares. The Schedule 13D said "Libco may be deemed to own beneficially an additional 12,500 shares of OSI owned of record by the Reliable Manufacturing Corporation Employees Profit Sharing Trust ('Reliable Trust')," and it stated that Libco could elect the directors of Reliable who in turn appointed the Reliable Trust administrators. The statement also noted that Zuckerman was a director of both Libco and Reliable, president of Reliable and one of the Reliable Trust administrators. In the Schedule 13D, Libco expressly disclaimed "any beneficial interest in the assets of the Reliable Trust." [13]

In early 1979 the Engle group battled OSI management for control of the company through two tender offers and a proxy fight. Documents filed in the tender offers continued to show the relationship between the Reliable Trust and other group members. Dardick acted as attorney for Telco in the tender offers and for Telvest in the proxy fight. During the proxy fight, Dardick ordered the Harris Bank as trustee to vote the trust's shares in favor of the Telvest slate of directors on April 24, 1979. During these struggles, Dardick was sharply critical of OSI management and the company's profitability. At the same time, Dardick controlled the Reliable Trust's investments in OSI, and his statements indicate that he believed the investments could have turned out well only if OSI management could have been replaced, or if the

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very little profit on the Hickory investments. *See supra* note 9.

[11] Telco, Libco, Engle and Sierra filed a Schedule 13D with the Securities and Exchange Commission in April 1978 regarding their purchases of Berkeley stock. In the list of Berkeley shares held by the reporting persons and their associates, the Reliable Trust shares of Berkeley were included. Their inclusion in the list is by no means conclusive as to whether the trust shares were "used by" the Engle group. However, the inclusion of the Reliable Trust's holdings in the SEC filing is clear evidence that the reporting persons—Engle, Libco, Telco and Sierra—knew of the trust's Berkeley investments.

[12] Defendants apparently contend that this inclusion of the Reliable Trust shares in the settlement was a generous act to benefit the trust. Brief of Defendants at 37.

[13] Neither the mention of the trust's shares nor the disclaimer is conclusive regarding the use of the trust's assets. However, the filing is clear evidence that Libco, Telco and Engle (who signed the filing for Telco) knew of the trust's investments in OSI. *See supra* note 11.

trust could have sold its shares to a "white knight" for a premium.

By May 1979, the Engle group controlled 21.73% of OSI shares. The control contest ended when the Brown Group, Inc., entered as a "white knight" on behalf of OSI management and tendered $15.00 per share of OSI stock. On June 26, 1979, the Reliable Trust sold its OSI shares to the Brown Group for a profit of 141%.

3. *Hickory Furniture investments:* Hickory was the third investment target, and the Engle group succeeded in purchasing a majority of Hickory stock by October 1979. The Reliable Trust bought 8000 shares of Hickory on March 22, 1978. At that time, Libco and GSC already owned 50,400 shares, and the trust purchases gave the group 4.88% of outstanding Hickory stock. After the April 21st Telco meeting, Telco and later Telvest steadily acquired Hickory stock.[14] The Reliable Trust purchased an additional 4000 shares of Hickory on June 9, 1978. Hickory management did not resist the Engle group investments, and on June 28th, Engle became a member of the Hickory board of directors. By the end of 1978, the Engle group owned 32.8% of Hickory, and their holdings grew to 52.8% in October 1979. The Reliable Trust sold its 12,000 shares of Hickory on March 19, 1979, one year after its initial purchase, for a net profit of 4%.

C.

The case before us was tried in the district court before Judge Leighton in September 1982. The district court granted judgment for defendants in an unpublished memorandum issued November 18, 1982. The district court held first that ERISA does not create a cause of action where the plan does not suffer financial loss. Conclusion of Law No. 10. The district court also found that the defendants did not use the Reliable Trust assets for their own purposes and that the assets were used exclusively in the interest of the trust beneficiaries. Findings of Fact Nos. 11, 12, 13 and 18; Conclusions of Law Nos. 4 and 15. The district court held that Dardick, Zuckerman and the National Boulevard Bank were fiduciaries of the trust, but that they had not violated their duties under ERISA sections 404 and 406, 29 U.S.C. §§ 1104 and 1106, by investing the trust assets in Berkeley, OSI and Hickory. Conclusions of Law Nos. 2, 4, 5, 6 and 15. The court concluded that the plan assets had been used for the exclusive benefit of the plan beneficiaries, Conclusion of Law No. 15, and that the plan administrators acted in good faith, Finding of Fact No. 23. The court also concluded that Dardick, Zuckerman and the National Boulevard Bank did not breach their co-fiduciary obligations under 29 U.S.C. § 1105(a). The court held further that Engle, Libco, Telco and Telvest had not exercised discretionary authority over the Reliable Trust and were not fiduciaries with respect to the investment or administration of its assets. Findings of Fact Nos. 21 and 22; Conclusion of Law No. 7. The court awarded expenses and attorneys' fees to all defendants and held that Dardick, Zuckerman and the National Boulevard Bank were entitled to reimbursement of expenses and fees from the trust's remaining assets. Conclusion of Law No. 16.

II.

[1] The Reliable Trust's investments in Berkeley, OSI and Hickory produced in the aggregate the extraordinary return on investment of 72%, exclusive of dividends.[15] It is clear that the trust lost no money in

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[14] Libco and Telco filed a Schedule 13D with the Securities and Exchange Commission in May 1978 regarding their purchases of Hickory stock. Later filings to update the original Schedule 13D describe the Reliable Trust's holdings of Hickory stock and say that "Libco may be deemed to own beneficially" the trust's shares. Libco also disclaimed "any beneficial interest in the assets of the Reliable Trust." Again, the statements in the SEC filings are not conclusive as to whether the Engle group used the Reliable Trust's assets in its acquisition program. *See supra* notes 11 and 13. Nevertheless, the filings clearly show that Telco, Libco and Engle were aware of the Reliable Trust's Hickory investments.

[15] See *supra* note 9.

the challenged transactions. The district court held that ERISA creates no cause of action where a breach of fiduciary duty does not cause financial harm to the benefit plan, Conclusion of Law No. 10, but the district court erred in this statement of the law. ERISA clearly contemplates actions against fiduciaries who profit by using trust assets, even where the plan beneficiaries do not suffer direct financial loss.[16] A fiduciary who breaches his duties "shall be personally liable ... to restore to such plan any profits of such fiduciary which have been made through use of assets of the plan by the fiduciary." 29 U.S.C. § 1109(a).

The nature of the breach of fiduciary duty alleged here is not the *loss* of plan assets but instead the *risking* of the trust's assets at least in part to aid the defendants in their acquisition program. ERISA expressly prohibits the use of assets for purposes other than the best interests of the beneficiaries, and the language of section 1109(a) providing for disgorgement of profits from improper use of trust assets is the appropriate remedy.[17] On the record before us, we are unable to determine the extent of the defendants' total profits, and we certainly cannot measure the extent, if any, to which any profits resulted from the defendants' use of the trust assets. However, those questions are relevant only in measuring damages. *See infra* Part VI. At this point in the analysis, we need only say that plaintiffs are not required to show that the trust lost money as a result of the alleged breaches of fiduciary duties. If ERISA fiduciaries breach their duties by risking trust assets for their own purposes, beneficiaries may recover the fiduciaries' profits made by misuse of the plan's assets.

III.

ERISA requires those who control employee benefit plans to act solely in the interests of the plan beneficiaries. The fiduciary duties of those who control benefit plans are set forth in part 4 of Title I of ERISA. Two sections are applicable to this case. First, section 404(a), 29 U.S.C. § 1104(a), codifies and makes applicable to fiduciaries[18] certain principles developed in the law of trusts.[19] H.R.Rep. No. 533, 93rd Cong., 1st Sess. 11, 13, *reprinted in* 1974 U.S. Code Cong. & Ad.News 4639, 4649, 4651. Section 404(a)(1) provides in relevant part that:

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[16] The district court's reliance on *Alton Memorial Hospital v. Metropolitan Life Ins. Co.*, 656 F.2d 245, 249 (7th Cir.1981), is misplaced. That case involved a contractual dispute between an employer who maintained a pension plan and the enrolled actuary of the plan. This court there held that the actuary could not invoke ERISA's fiduciary standards to recover from the employer in the contractual dispute between them. It was clear that the interests of the plan beneficiaries were not affected in any way, and thus ERISA did not create a cause of action on behalf of the actuary. In the present case, by contrast, the interests of plan beneficiaries were directly affected. The defendants appear to have risked the trust assets in part to serve their own purposes rather than solely the interests of the beneficiaries. With its focus on protecting the interests of plan beneficiaries, ERISA clearly prohibits such actions, and the provisions in section 1109(a) for disgorgement of profits are the remedy to deter such violations.

[17] The legislative history of ERISA shows that Congress intended disgorgement of profits to be one remedy available for breach of fiduciary duty. A fiduciary who breaches this duty "must restore to the plan any profits which he made using plan assets." S.Rep. No. 383, 93rd Cong., 1st Sess. 105, *reprinted in* 1974 U.S.Code Cong. & Ad.News 4890, 4988. The disgorgement provisions of § 1109(a) are in accord with the common law of trusts. *See* Restatement (Second) Of Trusts § 205(b), comment (h), and § 206 comment (j) (1959). *See also Home Federal Savings & Loan Ass'n v. Zarkin*, 89 Ill.2d 232, 59 Ill.Dec. 897, 432 N.E.2d 841, 848 (1982). The purpose of this strict rule is to deter breaches by denying fiduciaries any profits from their misuse of assets. G. Bogert, The Law Of Trusts And Trustees § 543 at 218 (rev. 2d ed. 1978).

[18] "Fiduciary" is defined in ERISA as follows:

> (A) Except as otherwise provided in subparagraph (B), a person is a fiduciary with respect to a plan to the extent (i) he exercises any discretionary authority or discretionary control respecting management of such plan or exercises any authority or control respecting management or disposition of its assets, (ii) he renders investment advice for a fee or other compensation, direct or indirect, with respect to any moneys or other property of such plan, or has any authority or responsibility to do so, or (iii) he has any discretionary authority or discretionary responsibility in the administration of such plan. Such term includes any person designated under section 1105(c)(1)(B) of this title.

29 U.S.C. § 1002(21)(A). We discuss below the application of this definition to the defendants in this case.

> a fiduciary shall discharge his duties with respect to a plan solely in the interest of the participants and beneficiaries and—
>
> (A) for the exclusive purpose of:
>
> (i) providing benefits to participants and their beneficiaries; and
>
> (ii) defraying reasonable expenses of administering the plan;
>
> (B) with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims ....

29 U.S.C. § 1104(a)(1). For the case before us, the key provisions are those requiring the fiduciary to act "solely in the interest" of plan beneficiaries and for "the exclusive purpose" of providing benefits. Other federal courts have described the duty of loyalty under ERISA as the duty to act with "complete and undivided loyalty to the beneficiaries of the trust," *Freund v. Marshall & Ilsley Bank*, 485 F.Supp. 629, 639 (W.D. Wis.1979), and with an "eye single to the interests of the participants and beneficiaries," *Donovan v. Bierwirth*, 680 F.2d 263, 271 (2d Cir.), *cert. denied*, 459 U.S. 1069, 103 S.Ct. 488, 74 L.Ed.2d 631 (1982).

Second, section 406 of ERISA, 29 U.S.C. § 1106, prohibits transactions in which the potential for misuse of plan assets is particularly great. The prohibited transaction rules focus primarily on the relationship between the benefit plan and other parties to a transaction, and the section prohibits transactions where those dealing with the plan may have conflicting interests which could lead to self-dealing. For example, section 406(a)(1)(B) prohibits loans between benefit plans and parties in interest. The *per se* rules of section 406 make much simpler the enforcement of ERISA's more general fiduciary obligations. *See* S.Rep. No. 383, 93rd Cong., 1st Sess. 95, *reprinted in* 1974 U.S.Code Cong. & Ad.News 4890, 4979.

Section 406 also includes broader language which may require a more detailed analysis of the fiduciary's actions. The provisions relevant to this case are:

> (a) Except as provided in section 1108 of this title:
>
> (1) A fiduciary with respect to a plan shall not cause the plan to engage in a transaction, if he knows or should know that such transaction constitutes a direct or indirect—
>
> * * * * * *
>
> (D) transfer to, or use by or for the benefit of, a party in interest, of any assets of the plan....
>
> * * * * * *
>
> (b) A fiduciary with respect to a plan shall not—
>
> (1) deal with the assets of the plan in his own interest or for his own account ....

29 U.S.C. § 1106. The relevant language here is quite broad: "use by or for the benefit of, a party in interest," § 1106(a)(1)(D),[20] and "deal ... in his own interest," § 1106(b)(1).

The district court found that Dardick and Zuckerman did not breach their fiduciary duties under ERISA by purchasing and holding stock in Berkeley, OSI and Hickory. The court found that the purchases were made upon the advice of Newbill and were intended to diversify the plan's investments. The court also held that it was not improper for the Reliable Trust to hold its stock in Berkeley, OSI and Hickory after Telco made major purchases of the stocks. The court concluded that the trust's investments were prudent and made exclusively for the benefit of the trust beneficiaries. The court also found that the purchases were not prohibited transactions under section 406. The district court therefore concluded that Dardick and Zuckerman did not breach their fiduciary duties under section 404 and section 406.

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[19] As one district court has stated:

> The legislative history of the [fiduciary duty] sections of ERISA indicates, that to the extent practical, the obligations of trustees of pension funds and the limitations on their power of investment were to be interpreted under principles applicable to trustees under the common law of trusts, with a view toward establishing uniform standards.

Marshall v. Teamsters Local 282 Pension Trust Fund, 458 F.Supp. 986, 990 (E.D.N.Y.1978) (fn. omitted).

[20] ERISA defines "party in interest" at 29 U.S.C. § 1002(14). The definition includes Reliable Manufacturing, Libco, Telco, Telvest, Engle, Zuckerman, Dardick and the National Boulevard Bank. 29 U.S.C. § 1002(14)(A), (B), (C), (E), (G) and (H).

[2, 3] We must accept the district court's findings of fact unless we find them "clearly erroneous." Fed.R.Civ.P. 52(a); *Clark v. Universal Builders, Inc.*, 706 F.2d 204, 206 (7th Cir.1983). In this case, however, many of the district court's most important "Findings of Fact" regarding the use of the trust's assets are mixed findings of fact and law. *See* Findings of Fact Nos. 11, 12, 13, 17, 18, 19, 21, 22. Our review of these findings is consequently less deferential than it might otherwise be. *Harrison v. Indiana Auto Shredders Co.*, 528 F.2d 1107, 1120 (7th Cir.1975). *See Lektro-Vend Corp. v. Vendo Co.*, 660 F.2d 255, 262–63 (7th Cir.1981) (review of mixed findings and "paper" cases), *cert. denied*, 455 U.S. 921, 102 S.Ct. 1277, 71 L.Ed.2d 461 (1982). Further, the evidence relevant to our conclusions on the critical issues in this case consists of documents and undisputed oral testimony. The district court's findings on issues where the observation of witnesses is critical are, of course, fully subject to the clearly erroneous rule. However, the district court's findings as to the defendants' credibility and good faith are not relevant to our disposition of this case, and thus we do not decide whether they were clearly erroneous. *See* Finding of Fact No. 23. This litigation concerns the legal significance of undisputed facts—the disputed issues of credibility and subjective good faith simply do not come into play. Good faith is not a defense to an ERISA fiduciary's breach of the duty of loyalty. *See Donovan v. Bierwirth*, 538 F.Supp. 463, 470 (E.D.N.Y. 1981), *aff'd as modified*, 680 F.2d 263 (2d Cir.), *cert. denied*, 459 U.S. 1069, 103 S.Ct. 488, 74 L.Ed.2d 631 (1982).

[4] In our view, application of ERISA's fiduciary standards to the Reliable Trust's investments in the corporate control contests here requires us to reverse the judgment below. The undisputed facts in the record show that the district court clearly erred when it concluded that plan assets were used exclusively in the interests of beneficiaries. The Reliable Trust administrators did not act solely in the interests of the plan beneficiaries where they invested the trust's assets in companies involved in corporate control contests, where the administrators themselves were actively engaged in the control contests and had substantial interests in them, where the administrators failed to make an intensive and independent investigation of the investment options open to the trust and where the trust's investment decisions never deviated from the best interests of the Engle group.

A. *Fiduciary Standards of Section 404.* The Second Circuit applied the fiduciary standards of section 404 to fiduciaries' conduct in a contest for corporate control in *Donovan v. Bierwirth*, 680 F.2d 263 (2d Cir.), *cert. denied*, — U.S. —, 103 S.Ct. 488, 74 L.Ed.2d 631 (1982). At issue were the actions of Grumman Corporation's pension fund trustees during the Grumman-LTV takeover battle. The trustees were also Grumman officers. The district court had stated that Grumman corporate insiders with fiduciary duties to the corporation's pension fund would be tested against a standard requiring them to undertake a vigorous and independent investigation into the wisdom of the contemplated investment in order to meet the section 404(a)(1)(B) standards:

> [their] independent investigation into the basis for an investment decision which presents a potential conflict of interests must be both intensive and scrupulous and must be discharged with the greatest degree of care that could be expected under all the circumstances by reasonable beneficiaries and participants of the plan.

Donovan v. Bierwirth, 538 F.Supp. 463, 470 (E.D.N.Y.1981), *aff'd as modified,* 680 F.2d 263 (2d Cir.), *cert denied,* 459 U.S. 1069, 103 S.Ct. 488, 74 L.Ed.2d 631 (1982).

Writing for the Second Circuit on appeal, Judge Friendly considered two approaches to analyzing the trustees' duty of loyalty in managing plan assets during the takeover battle. The first approach focused on the existence of conflicting interests between the trustees and the plan beneficiaries. The pension trustees were obliged to make their decisions, Judge Friendly wrote, "with an eye single to the interests of the participants and beneficiaries." 680 F.2d at 271. That duty of loyalty imposed upon the trustees a duty "to avoid placing themselves in a position where their acts as officers and directors of the corporation will prevent their functioning with the complete loyalty to participants demanded of them as trustees of a pension plan." *Id.*[21] Where the plan trustees were officers of the takeover target, and where they clearly had substantial career and financial interests in the outcome of the control contest, the court said it believed it would have been "almost impossible" for the trustees to have decided to use the trust assets in ways which would weaken their own position in the control contest, regardless of the interests of the plan beneficiaries. 680 F.2d at 272. Thus, the first approach the Second Circuit considered would require fiduciaries who face substantial conflicts of interest in corporate control contests to step aside so that a neutral trustee could act for the duration of the control contest. The court approved of this approach, 680 F.2d at 271–72, but chose to rest its decision instead on the second approach which examined in great detail the trustees' investigation of the alternatives open to them. The court held that the trustees' investigations did not amount to the thorough, careful and impartial investigation needed to justify actions which would, at least incidentally, benefit themselves and their corporation, apart from their effects on the beneficiaries of the trust:

> they should have realized that, since their judgment on this score could scarcely be unbiased, *at the least they were bound to take every feasible precaution to see that they had carefully considered the other side,* to free themselves, if indeed this was humanly possible, from any taint of the quick negative reaction characteristic of targets of hostile tender offers . . ., and particularly to consider the huge risks attendant on purchasing additional Grumman shares at a price substantially elevated by the tender offer.

680 F.2d at 276 (emphasis supplied).

Under the section 404(a) duty of loyalty, the central question is whether the fiduciaries acted solely in the interests of the beneficiaries and for the exclusive purpose of providing them with benefits. The two approaches considered in *Donovan v. Bierwirth* offer two avenues for dealing with this central question. The first avenue focuses on the potential for conflicts of interest between the fiduciaries and the plan beneficiaries. Where the potential for conflicts is substantial, it may be virtually impossible for fiduciaries to discharge their duties with an "eye single" to the interests of the beneficiaries, and the fiduciaries may need to step aside, at least temporarily, from the management of assets where they face potentially conflicting interests. The second avenue involves a broader inquiry into the fiduciaries' actions where they may have substantial interests in a control contest. In *Donovan v. Bierwirth,* the Second Circuit focused on the fiduciaries' actions in investigating the investment options open to the plan during the corporate control contest. Where it might be possible to question the fiduciaries' loyalty, they are obliged at a minimum to engage in an intensive and scrupulous independent investigation of their options to insure that they act in the best interests of the plan beneficiaries. 538 F.Supp. at 470; 680 F.2d at 272. In the case before us, we believe there is an additional factor which weighs heavily in evaluating the loyalty of the fiduciaries. Here the control efforts lasted for several months, and in the case of Hickory, for over a year. The Reliable Trust held its shares involved in the control contests throughout these periods, and, as we discuss below, the trust's use of its assets at all relevant times tracked the best interests of the Engle group in the control contest. We believe that the extent and duration of these actions congruent with the interests of another party are also relevant for courts in deciding whether plan fiduciaries were acting solely in the interests of plan beneficiaries.

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[21] We recognize, as did the court in *Donovan v. Bierwirth,* that ERISA contains express exceptions which permit fiduciaries to act in a few limited situations where their interests and those of plan beneficiaries may diverge. *See* 29 U.S.C. § 1108. However, the exceptions of section 1108 are quite limited, and abuses are reasonably easy to detect where, for example, a trustee pays himself an excessive salary. None of the exceptions in section 1108 is applicable here.

[5] B. *Prohibited Transactions Under Section 406.* Before discussing the application of the fiduciary standards to this case, we must also examine the applicability of the prohibited transaction provisions of section 406. In *Donovan v. Bierwirth,* the Second Circuit declined to apply the prohibited transaction provisions of section 406 to that case involving the use of an employee pension plan's assets to defend the employer from a hostile tender offer. 680 F.2d at 270. Specifically, the court there refused to apply the provisions of section 406(b)(2) prohibiting a fiduciary from acting on behalf of a party with interests adverse to the plan or its participants and beneficiaries. The Second Circuit stated that subsection (b)(2) was the only "arguably applicable" provision in section 406. The court said:

> We see no reason to think Congress intended the expansive interpretation of the various specific prohibitions of § 406 urged by the Secretary, particularly in light of the inclusion of the sweeping requirements of prudence and loyalty contained in § 404.

680 F.2d at 270.

However, we believe that the protective provisions of section 406(a)(1)(D) and (b)(1) should be read broadly in light of Congress' concern with the welfare of plan beneficiaries. We read those provisions dealing with the use of plan assets for the benefit of "parties in interest" and plan fiduciaries as a gloss on the duty of loyalty required by section 404.

We do not believe that Congress intended the language "use by or for the benefit of, a party in interest," § 406(a)(1)(D), and "deal . . . in his own interest," § 406(b)(1), to be interpreted narrowly. The entire statutory scheme of ERISA demonstrates Congress' overriding concern with the protection of plan beneficiaries, and we would be reluctant to construe narrowly any protective provisions of the Act.

The broad provisions of section 406(a)(1)(D) and (b)(1) require courts to look carefully at the transaction to decide whether plan assets were used "by or for the benefit of" a party in interest, or whether a fiduciary dealt with the plan assets "in his own interest." Application of these provisions may require courts to engage in the same searching investigation into the objective circumstances of the fiduciary's actions needed to apply the fiduciary loyalty provisions of section 404(a)(1).

[6] Section 406(a)(1)(D) should be read to cover the actions of a trustee who buys shares in a target corporation in order to assist either the target's management or the raider in its quest for corporate control or a "control premium." If the corporation which the fiduciary seeks to aid qualifies as a "party in interest," we see nothing in the language or legislative history of subsection (a)(1)(D) which would preclude a court from treating the purchase as the use of plan assets for the benefit of a party in interest, at least where other evidence shows the fiduciary's purpose. *See Dimond v. Retirement Plan,* 582 F.Supp. 892, 4 EMPLOYEE BEN.CAS. (BNA) 1457, 1463 (W.D.Pa.1983) (enjoining use of plan assets to protect employer's incumbent management). The legislative analysis of subsection (a)(1)(D) clearly anticipates such an application of the subsection:

> [Subsection (a)(1)(D)] prohibits the direct or indirect transfer of any plan income or assets to or for the benefit of a party-in-interest. It also prohibits the use of plan income or assets by or for the benefit of any party-in-interest. As in other situations, *this prohibited transaction may occur even though there has not been a transfer of money or property between the plan and a party-in-interest. For example, securities purchases or sales by a plan to manipulate the price of the security to the advantage of a party-in-interest constitututes [sic] a use by or for the benefit of a party-in-interest of any assets of the plan.*

H.R.Conf.Rep. No. 1280, 93rd Cong., 2d Sess. 308, *reprinted in* 1974 U.S.Code Cong. & Ad.News 5038, 5089 (emphasis supplied).

In addition, subsection (b)(1) could be applicable to an administrator's investment activities in the context of a corporate control contest, particularly when the administrator is also an officer of the sponsoring corporation or a closely related entity. Subsection (b)(1) requires that a trustee not deal with the assets of the plan "in his *own* interest." (Emphasis supplied.) *See Freund v. Marshall & Ilsley Bank*, 485 F.Supp. 629, 637 (W.D.Wis.1979) (section 406(b) prohibits fiduciary from acting where personal interests may conflict with plan's interest). The question is how broadly "interest" should be read. While it would surely cover trustee interests of a financial nature, one commentator has argued that courts should not limit the section to financial interests:

> The absence of a direct financial interest in the transaction, however, should not preclude the application of this section to officer-trustees, as the prohibited transaction rules are designed to prevent the use of plan assets for any interest, financial or nonfinancial, other than an interest of the plan and its beneficiaries.

Note, *The Duties of Employee Benefit Plan Trustees Under ERISA in Hostile Tender Offers*, 82 Colum.L.Rev. 1692, 1703 n. 51 (1982). In light of ERISA's broad language and protective provisions, we agree that we should read broadly the term "interest" in section 406(b)(1).[22] Thus, in a contest for corporate control, plan trustees who are also officers of either the "target" or the "raider" could be seen as having a significant "interest" of their own in the outcome of the contest. Officers of the "target" might well be immediately concerned about holding onto their jobs. Officers of the "raider" might find it in their interest, in terms of maintaining good relations with their superiors, for example, to assist their corporation in its acquisition efforts.

C. *ERISA and the Reliable Trust Investments.* Under ERISA sections 404(a), 406(a)(1)(D) and 406(b)(1), where plaintiffs allege that fiduciaries have used plan assets for their own purposes in a corporate control contest, courts must examine closely the circumstances surrounding the alleged use of plan assets. In this case, several factors are relevant in deciding whether the plan administrators acted solely in the interests of the plan beneficiaries. First, the risk of conflicts between the interests of the fiduciaries and beneficiaries is the key warning signal for possible misuse of plan assets. Second, whether fiduciaries with divided loyalties make an intensive and scrupulous investigation of the plan's investment options may be highly probative of the fiduciaries' loyalties. Third, the consistent management of plan assets in congruence with the fiduciaries' personal interests over a substantial period of time in control contests may be probative of whether the fiduciaries have acted solely in the interests of the beneficiaries. This list is by no means exhaustive, but these are the factors applicable here.

On the record before us, we find that the district court clearly erred when it found that the Reliable Trust's investments in Berkeley, OSI and Hickory were made and held solely in the interests of the plan beneficiaries. We find that Dardick's and Zuckerman's investment of the trust's assets in

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[22] Where dealings between the fiduciary and the plan are necessary, the exemptions of 29 U.S.C. § 1108 will adequately protect the fiduciary.

Berkeley, OSI and Hickory violated ERISA's fiduciary requirements.

With regard to the Berkeley, OSI and Hickory investments, both Dardick and Zuckerman faced the clear risk of conflicting interests. As fiduciaries of the Reliable Trust, their duty was to promote the interests of the trust beneficiaries. Yet their ties to the Engle group and their involvement in the control contests gave them other interests which clearly could diverge from those of the beneficiaries. For example, as the Engle group began to expand its holdings, it benefited by keeping Berkeley, OSI and Hickory stock prices as low as possible in the short run, thereby reducing the cost of its acquisition plans. The Engle group's success in the control contests depended upon the group's ability to control the largest possible block of shares.

The interests of Reliable Trust beneficiaries were markedly different. Their interests were best served by quickly rising stock prices, which often result from corporate control struggles. They certainly had no interest in preventing or delaying price rises. Further, the interests of the beneficiaries required disposing of the stock if it appeared that the investment had no further profit potential. Thus, if fully independent, the persons administering the trust might have wanted to sell the stock before the rest of the Engle group was in a position to cash in its own position. The beneficiaries were interested in the greatest possible return on their investment, regardless of whether their investments aided one side or another in a control contest. Further, independent trust administrators might have sold out earlier (or might never have bought in) if they believed that target management was acting contrary to the best interests of the stockholders.

Thus, as unpaid trust administrators, Dardick and Zuckerman faced responsibilities which could have conflicted sharply with the interests of the Engle group (upon which their income depended) in its control contests. Had a time come when a decision had to be made that would hurt the Reliable Trust and help Engle, or vice-versa, while Engle was effectively providing everyone's paycheck, we think it unrealistic to expect that the decision would not go in Engle's favor.[23] To the extent the Reliable Trust and other entities in the Engle group were stockholders in the same target companies, they shared, of course, an interest in the ultimate maximization of the stock values. In that general sense, the interests were not in actual conflict. However, because the plaintiffs have shown that the trust administrators clearly faced potentially conflicting interests and continued to exercise control over the plan assets in ways that directly benefited the Engle group, grave doubts arise concerning the administrators' loyalty. Under these circumstances, it was virtually impossible for the plan fiduciaries to act with complete loyalty to the Reliable Trust beneficiaries and with an "eye single to the interests of the participants and beneficiaries." *Donovan v. Bierwirth, supra,* 680 F.2d at 271.[24]

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[23] When the plaintiffs filed this action in September 1978, the potential conflicts may well have ripened into actual conflicts. The plaintiffs sought immediate distribution of their trust interests, and, as we discuss below in Part V, they may well have been entitled to immediate distribution. When the lawsuit was filed, the Reliable Trust still held its shares of OSI and Hickory, and the control contests for those companies were not over. Yet the trust administrators did not distribute most trust assets until after the control contests had ended. The district court found that the delays were reasonable, and we vacate that finding in Part V. On the record before us, we are reluctant to reverse the district court's finding and hold that the delayed distribution violated ERISA as a matter of law. We leave to the district court on remand the issues whether the fiduciaries' actions in delaying distribution violated the trust instruments or ERISA's standard of loyalty.

[24] The potential conflicts in the case before us seem, on the surface, at least, less severe than the one faced by the trust administrators in *Donovan v. Bierwirth,* where the administrators' positions in target management, and their presumed concern for their own jobs, might have been influences strongly adverse to the trust's interests as a stockholder. Nonetheless, the potential conflicts in this case were substantial enough to create the risk of misuse of plan assets.

Because of the other factors present in this case, we need not decide whether the potential conflicts alone amounted to ERISA violations. Where they faced these clearly conflicting loyalties, Dardick and Zuckerman undertook no genuinely independent investigation of the trust's investment options. At the very least they should have realized that their ties to the Engle group and their interests in the control contests cast serious doubt on their ability to act solely in the interests of the beneficiaries. Yet before the trust purchased the stocks and throughout the several control contests, Dardick and Zuckerman failed to seek independent advice which might have clarified where the interests of the beneficiaries lay.

Defendants contend that the trust's Berkeley purchases were prudent investments made upon the advice of the professional investment advisor, Charles Newbill. The reliance on Newbill's advice does not alter our conclusion that the investments were not made for the exclusive purpose of providing benefits to plan beneficiaries. On the contrary, in light of Newbill's ties to the entire Engle group, *see supra* Part I–A, his blessing of the trust's investments only adds support to the inference that the trust purchases were part of the Engle group's investment and acquisition program. First, at the time Newbill proposed the Berkeley investments to Dardick, Newbill's only paying client was Libco. The bill Newbill submitted to the Reliable Trust for the advice was prepared nine months after the purchases and three months after this lawsuit was filed. Newbill apparently made his recommendations in several conversations with Dardick during early 1978 and in several brief memoranda dated a few days before the trust made its purchases. *See* Defendants' Exhibits ZZ and AAA. Dardick and Zuckerman clearly knew of Newbill's involvement with Engle and Libco, and they were aware of Engle's and Libco's interest in the three companies. If Dardick and Zuckerman had been acting independently, we do not see how they could have failed to make their own investigation or to seek the advice of someone not involved in the Engle group's acquisition efforts.[25]

Thus it is clear that the Reliable Trust investments in Berkeley, OSI and Hickory were made by administrators who faced conflicting loyalties and who made no effort to obtain independent advice regarding these investments and the interests of the trust beneficiaries. When we also examine the timing of the trust's investment decisions and their relationship to the actions of other members of the Engle group, it is clear that the trust's investments were not made with an "eye single" to the interests of the participants and beneficiaries. *Donovan v. Bierwirth, supra,* 680 F.2d at 271. Instead, the trust investments were made at least in part to enhance the Engle group's position in the several control contests.

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[25] Defendants argue further that the Berkeley purchases, as well as those of OSI and Hickory, were prudent and made to diversify the trust's assets. To support this claim, defendants point to the testimony of Lee Meyer, a Harris Bank officer, who testified that the Harris Bank had also purchased Berkeley shares in the Special Capital Fund it managed for many employee benefit plans. Defendants' Brief at 19, 38. However, Meyer also testified that the Special Capital Fund was "a highly speculative fund, high risk fund," and a "go-go fund." Transcript at 613, 620. He testified that the bank never put more than 5% of any single trust's assets in the Special Capital Fund because the investments were high risk. Transcript at 613. The narrow issue of prudence is not precisely before us on this appeal. However, the speculative nature of the Reliable Trust's investments and the fact that the investment in Berkeley apparently appreciated primarily through the use of litigation as an economic weapon indicate whether the plan administrators acted with unswerving loyalty to the trust beneficiaries.

Additionally, defendants point out that the Reliable Trust's investments had all been held in the form of fixed income securities until March 1978, and that they were required to diversify these holdings. *See* 29 U.S.C. § 1104 (a)(1)(C). We do not question the need for diversification; in the abstract, it was entirely proper for the trust to purchase common stocks. However, the problem in this case is the particular choice of stocks in light of the other defendants' holdings in Berkeley, OSI and Hickory, and in light of the administrators' own interests, previously discussed, in these companies. A general need or desire for diversification cannot serve to justify the choice of the stocks purchased in this case.

The timing of the Reliable Trust purchases of Berkeley stock in relation to other actions of the Engle group shows that the trust assets were not used exclusively to further the interests of the trust beneficiaries. In late February 1978, Engle learned of the proposed deal between Berkeley management and the Cooper group trying to take over the company. At that time, Engle believed that the proposed deal would work to the disadvantage of minority shareholders such as himself and GSC. Although they faced the danger of being "locked-in" as minority shareholders under hostile management, Engle and GSC purchased an additional 11,200 shares between February 27th and March 10th, increasing the Engle group's Berkeley holdings from 3.5% to 4.0% by March 10th. Then, on March 22, 1978, letters were sent on GSC letterhead to the outside directors of Berkeley protesting the proposed Berkeley-Cooper deal. The letters were sent in Engle's name, but Dardick (who was, of course, at the same time the Reliable Trust administrator) prepared the letters and signed them for Engle. On April 7, 1978, Sierra, Engle and GSC filed suit against Berkeley and Cooper in the federal district court for the Northern District of Illinois. The complaint sought to enjoin the proposed deal, and Dardick prepared and signed the complaint. Thus, as attorney for Engle, Sierra and GSC, Dardick was arguing that Berkeley management was acting against the interests of minority shareholders, and he was suing management to stop the Berkeley-Cooper deal.

Meanwhile, between March 17th and March 31st, as administrators of the Reliable Trust, Dardick and Zuckerman were investing over $71,000 of the trust's assets in Berkeley stock. Under their direction, therefore, the Reliable Trust was becoming one of those minority shareholders against whose interests the Berkeley management was supposed to be acting. The Reliable Trust purchases of Berkeley stock increased the Engle group's block of Berkeley shares from 4.0% to 4.65% between March 17 and March 31, 1978. The suit by Engle, Sierra and GSC was settled in June 1978 by having Cooper Laboratories buy at a substantial premium the Berkeley shares owned by the Engle group. The Reliable Trust was not a party to the lawsuit, yet its Berkeley shares were also purchased as part of the settlement.[26]

We believe that undisputed facts in the record show that the Reliable Trust investments in Berkeley were made at least in part for the benefit of other members of the Engle group in their effort to acquire a substantial block of Berkeley shares. Engle's response to the Berkeley-Cooper deal was to gain control of more Berkeley shares and to sue Berkeley management to force a favorable settlement. We can see no reason for including the Reliable Trust shares in the ultimate settlement unless the trust's shares were in fact subject to the Engle group's control in the contest for control of Berkeley. One reason for the trust purchases of Berkeley stock was to increase the Engle group's control of Berkeley and, from the perspective of the trust, to gamble on the outcome of the expected litigation and control contest. As we noted above in Part II, the fact that the gamble paid off for the trust as well as for the rest of the Engle group is no defense in this action for breach of fiduciary duties.

The Reliable Trust investments in OSI stock show a similar pattern. The trust made its investments in OSI very early in the struggle for control of OSI. Before Telco began purchasing OSI stock on April 17, 1978, GSC, Engle and the Reliable Trust owned a total of 24,100 shares, or 1.67% of OSI. The trust owned 12,500 of those shares. Beginning on April 17th, Telco and later Telvest purchased OSI steadily, and the group's holdings grew to 6.2% by the end of May 1978, 9.7% by the end of July, 16% by the end of October, and 21.73% on May 4, 1979. Throughout the period of the Telco and Telvest purchases, the Engle group fought for control of OSI through litigation, two tender offers and a proxy fight. The Reliable Trust held its OSI shares during this time and ultimately sold them for an enormous profit when the Brown Group tendered $15.00 per share as a "white knight" protecting OSI management.

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[26] Of course, Dardick could also have been criticized if the trust shares had *not* been included in the settlement, for then the trust would not have received the control premium offered by Cooper. The dilemma stems from the fact that Dardick owed a fiduciary's duty of loyalty both to the trust and to the other members of the Engle group whose interests potentially diverged from those of the trust.

Dardick acted as attorney for the Engle group in the proxy fight, the tender offers and the ancillary litigation. On behalf of the Engle group he was sharply critical of OSI management and the company's profitability. His efforts were aimed at forcing OSI management to yield control or to purchase the Engle group's shares at a premium. At the same time, Dardick directly controlled the Reliable Trust's investments in OSI, and he directed the Harris Bank to vote the trust's shares in the proxy fight in favor of the Engle group's candidates for the board of directors.

Like the Reliable Trust's Berkeley investments, the OSI investments were made, held and used while the Engle group was engaged in a struggle for corporate control against the incumbent management. The trust administrators and the Reliable Manufacturing board of directors were all deeply involved in those struggles. They had significant interests of their own at stake in the outcome of the struggle. Clearly there was no one who had discretionary authority over the trust investments and who was disinterested in the struggles for corporate control. And throughout the control struggle lasting over a year, the Reliable Trust held its OSI shares and used them in accord with the Engle group's best interests.

The Hickory investments display the same pattern, although Hickory management decided not to resist the Engle group's efforts to gain control of the company. Again, the administrators faced conflicting loyalties, at least until it became clear that the Engle group would be successful in its acquisition efforts. The Engle group wanted to keep the stock price down in the short run, while an independent trust would probably have been interested in quickly rising stock prices. Again, there was no effort to obtain independent advice on the soundness of the trust's purchase and retention of Hickory shares. Throughout the long period during which the Engle group established its position in Hickory, the trust held its shares. Then, after it was clear that the Engle group would succeed, the trust sold its shares at a low point in the market for a net profit of 4%, including a loss on one-third of the shares it purchased. Under these circumstances, we conclude that the district court erred when it found that the defendants fulfilled their duties under ERISA.[27] Dardick and Zuckerman violated their duty of loyalty by investing the trust's assets in Hickory because they were not acting solely in the interests of the beneficiaries.[28]

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[27] The plaintiffs claim that defendants profited from their Hickory investments primarily through the use of "equity accounting," whereby as investors with "substantial influence" over Hickory, the defendants were able to include their share of Hickory's earnings in their own balance sheets. The district court found that the Reliable Trust's Hickory shares "played no part in the decision by, or ability of, Telco to use the equity method of accounting" with respect to its Hickory investments. Finding of Fact No. 15. That finding, which is not clearly erroneous, is relevant in determining whether and how the defendants profited from the trust's investments in Hickory. However, our conclusion that the investments violated ERISA's standard of loyalty does not depend upon the use of equity accounting or the extent of the profits made.

[28] Defendants point out that the trust made all of its Berkeley and OSI purchases, and most of its Hickory purchases, before Telco and Telvest made their larger purchases and before the contests for control began. They contend that these subsequent actions by other parties cannot transform the trust's earlier purchases into breaches of fiduciary duty. However, the argument misses the mark. First, before the trust made its purchases, other members of the Engle group had already begun to establish positions in the three companies, and Newbill was recommending the three companies to Engle and Libco as likely takeover candidates. Telco did not begin its larger purchases until April because it did not receive financing until shortly before the April 21st board meeting. Supplemental Appendix at 425. Most importantly, though, a fiduciary's duty is not limited merely to purchases. During the control contests the administrators also faced the continual choice of holding or selling their shares in the contested companies. Where the administrators faced the conflicting loyalties present in this case, their actions in *holding* the shares had the

[7] We conclude, therefore, that Dardick and Zuckerman violated their fiduciary duties under section 404(a), section 406(a)(1)(D) and section 406(b)(1) of ERISA by investing the Reliable Trust's assets in Berkeley, OSI and Hickory. We reach that conclusion because the fiduciaries had divided loyalties with clear potential for conflicts of interests, because the fiduciaries with divided loyalties failed even to seek independent, disinterested advice regarding these investments and their duties to the plan beneficiaries and because, throughout prolonged contests for corporate control, the fiduciaries' use of the trust assets dovetailed at all times with the interests of the Engle group.[29] Were we to reach another result in this case, we do not see how the interests of ERISA plan beneficiaries could be protected from those who would use trust property in contests for corporate control. The fiduciary's duty of loyalty is exacting, and the Reliable Trust administrators' use of the assets entrusted to them falls substantially short of that exacting standard.

Benefit plans subject to ERISA control an enormous pool of capital in today's economy. With their extensive investments in securities, they will frequently face difficult investment decisions in contests for corporate control. Therefore we emphasize that our finding of a breach of fiduciary duty in this case is predicated on the fiduciaries' intimate involvement with and interest in the other parties to the struggle for control. Where the plan fiduciary has interests outside the plan in a control struggle—interests which the benefit plan may be in a position to further or to impair—the risk is too great that the fiduciary will be unable to act as ERISA requires—solely in the interest of the plan beneficiaries.

As a practical matter, we view favorably the suggestion of the Secretary of Labor, as *amicus curiae*, that the preferred course of action for a fiduciary of a plan holding or acquiring stock of a target, who is also an officer, director or employee of a party-in-interest seeking to acquire or retain control, is to resign and clear the way for the appointment of a genuinely neutral trustee to manage the assets involved in the control contest.[30] Otherwise, the risk is too great that the trustee will come to a crossroads where the interests of the plan and the party-in-interest diverge. For example, while the party-in-interest may be seeking to accumulate as many shares as possible in order to maintain or acquire control, a plan's interest in maximizing its investment return may require it to tender its shares to a competing bidder for shares.[31]

The resignation of the interested fiduciary would also have the benefit of obviating in many cases the need for courts to sift through the complicated events surrounding a takeover in an attempt to gauge the prudence and motivations of trustees. Though neutral trustees will have the same fiduciary duties, we think it likely that the mantle of seeming objectivity worn by a

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effect of putting them in breach of their fiduciary obligations under ERISA. *See Donovan v. Bierwirth*, 680 F.2d at 272–74 (applying fiduciary standards to decisions to hold stock).

[29] We emphasize here that it is not *per se* impermissible for employee benefit plans to invest in companies involved in control contests or to ally themselves with one side or another in a control contest. The central issue is the *independence* of the plan fiduciaries who must always be able to act solely for the benefit of those whose funds are entrusted to them. In the case before us, where potential conflicts of interest are present, where the plan administrators are anything but independent and where these administrators fail to undertake any independent investigation of the investments, the long term congruence is additional evidence of the fiduciaries' breach of ERISA's duty of loyalty. The congruence alone would not demonstrate a breach of that duty of loyalty.

[30] It would not be necessary in all cases for the interested fiduciary to withdraw completely from plan management. The critical step is to have independent persons manage the assets involved in the control contest.

[31] Our holding in this case does not establish a *per se* rule based on potential conflicts of interest. We need not reach so far because here the fiduciaries with divided loyalties failed utterly to obtain independent advice from disinterested persons and because the trust's investment decisions were always congruent with the Engle group's interests. Nevertheless, we do not reject the *per se* standard here; should the proper case arise, we would need to decide the issue squarely.

neutral trustee will calm the fears of plan beneficiaries who might otherwise perceive the need to resort to the courts in order to ensure the safety of their entitlements.

IV.

[8] We must also consider whether Clyde Engle and Libco are fiduciaries with respect to the Reliable Trust's investments and, if so, whether they breached their fiduciary duties. ERISA provides that:

> a person is a fiduciary with respect to a plan to the extent (i) he exercises any discretionary authority or discretionary control respecting management of such plan or exercises any authority or control respecting management or disposition of its assets, (ii) he renders investment advice for a fee or other compensation, direct or indirect, with respect to any moneys or other property of such plan, or has any authority or responsibility to do so, or (iii) he has any discretionary authority or discretionary responsibility in the administration of such plan. Such term includes any person designated under section 1105(c)(1)(B) of this title.

29 U.S.C. § 1002(21)(A). The district court found that Engle did not have control or authority over the investment of plan assets except through his participation in the appointment of the plan administrators. Finding of Fact No. 21. The court concluded that Engle and Libco were not fiduciaries with respect to the plan's administration and investment. Conclusion of Law No. 7.

Plaintiffs argue that Engle and Libco come within the scope of section 1002(21)(A)(iii), which makes one a fiduciary to the extent a person "has any discretionary authority or discretionary responsibility in the administration of [a] plan." [32] Plaintiffs contend that Engle and Libco had such discretionary authority over the plan by virtue of Engle's control of Libco and Libco's 100% ownership and control of Reliable Manufacturing: Libco had the power to appoint and remove the directors of Reliable (Engle, Zuckerman and Contarsy) who, in turn, had the power to appoint and remove the trust administrators (Dardick and Zuckerman). Therefore, plaintiffs argue, "By virtue of their ability to control appointments of Reliable Trust Administrators, Libco and Engle were fiduciaries." Brief of Appellants at 23.

It is clear that Engle and Libco are fiduciaries to the extent that they performed fiduciary functions in selecting and retaining plan administrators. ERISA recognizes that a person may be a fiduciary for some purposes and not others. The defendants contend that although Engle and Libco may be fiduciaries for the purpose of selecting and retaining plan administrators, that status does not make Engle and Libco fiduciaries with respect to the administrators' investment decisions.

Defendants' argument that ERISA ties fiduciary responsibilities to a person's actual authority is correct. The key language in the statutory definition is that a person is a fiduciary "to the extent" he or she exercises control or authority over the plan. The Secretary of Labor explained this language in a bulletin interpreting ERISA, which was published in the Code of Federal Regulations. In this bulletin, the Secretary was asked the following question and gave the following response:

> D-4 Q: In the case of a plan established and maintained by an employer, are members of the board of directors of the employer fiduciaries with respect to the plan?
>
> A: Members of the board of directors of an employer which maintains an employee benefit plan will be fiduciaries only to the extent that they have responsibility for the functions described in section 3(21)(A) of the Act. For example, the board of directors may be responsible for the selection and retention of plan fiduciaries. In such a case, members of the board of directors exercise "discretionary authority or discretionary control respecting management of such plan" and are, therefore, fiduciaries with re-

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[32] Plaintiffs do not challenge on appeal the district court's conclusion that Telco and Telvest are not fiduciaries. *See* Brief for Appellants at 22-26.

> spect to the plan. *However, their responsibility, and consequently, their liability, is limited to the selection and retention of fiduciaries* (apart from co-fiduciary liability arising under circumstances described in section 405(a) of the Act). In addition, if the directors are made named fiduciaries of the plan, their liability may be limited pursuant to a procedure provided for in the plan instrument for the allocation of fiduciary responsibilities among named fiduciaries or for the designation of persons other than named fiduciaries to carry out fiduciary responsibilities, as provided in section 405(c)(2).
>
> The Internal Revenue Service notes that it would reach the same answer to this question under section 4975(e)(3) of the Internal Revenue Code of 1954.

ERISA Interpretative Bulletin 75-8, 29 C.F.R. § 2509.75-8 (1983) (emphasis supplied).

[9] This court has adopted a similar approach to analyzing fiduciary responsibilities under ERISA. *Brandt v. Grounds,* 687 F.2d 895, 897 (7th Cir.1982); *Chicago Bd. Options Exchange, Inc. v. Connecticut General Life Ins. Co.,* 713 F.2d 254, 259 (7th Cir.1983). In *Brandt,* we affirmed the dismissal of an action against a bank that had allowed a plan trustee to withdraw $175,000 from the plan's accounts. The trustee had obtained the money by forging, or by obtaining under false pretenses, the signature of another trustee. In addition to alleging a breach of the bank's duties as a depository for accepting the forged instruments, plaintiffs alleged that the bank had breached its fiduciary duties under ERISA by acting imprudently in violation of the prudent man standard of 29 U.S.C. § 1104(a)(1)(B). This court agreed that the bank may have been a fiduciary as a result of its providing investment advice for a fee, 29 U.S.C. § 1002(21)(A)(ii), but we held that "its fiduciary status existed only 'to the extent' that it provided that advice .... Thus, it appears that the personal liability of the Bank would be limited to its violations of 29 U.S.C. § 1104 in performing its investment advising functions." 687 F.2d at 897. The bank therefore was not a fiduciary with respect to its functions as a depository.

Similarly, in *Chicago Board,* we held that Connecticut General was a fiduciary because it had discretionary authority over management of plan assets by virtue of Connecticut General's power to amend its annuity contract with the Chicago Board Options Exchange. We noted, however, that Connecticut General's fiduciary status "only governs actions taken in regard to amending the contract and does not impose fiduciary obligations upon Connecticut General when taking other actions." 713 F.2d at 259.

Because Engle and Libco were fiduciaries with respect to the selection and retention of the plan administrators, the issue here is not whether they were fiduciaries but instead whether their fiduciary duties extended to the Reliable Trust investments in Berkeley, OSI and Hickory. The district court limited its analysis of this question to whether Engle and Libco directly exercised control over the Reliable Trust's investments. That analysis was too limited in scope.[33] The fact that Engle and Libco had

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[33] Under the district court's analysis, Engle and Libco were not fiduciaries with respect to the investments because plaintiffs did not show that Engle and Libco exercised direct control over the investments. On paper, it is true, Engle's authority over the Reliable Trust could be exercised only indirectly through his membership on the Reliable Manufacturing board which appointed the plan administrators. On paper, Libco could control the trust only through its power to appoint the Reliable Manufacturing board which in turn appointed the Reliable Trust administrators. However, we think ERISA directs courts to look beyond Engle and Libco's formal authority with respect to the plan, limited to selection and retention of administrators, and to consider what real authority they had over plan investments by virtue of their having appointed Dardick and Zuckerman to be administrators. *See Fulk v. Bagley,* 88 F.R.D. 153, 162 (M.D.N.C.1980) ("in defining 'fiduciary' Congress was peculiarly concerned with realities, as distinguished from mere formalities."); *Eaves v. Penn,* 587 F.2d 453, 458 (10th Cir.1978).

By selecting Dardick and Zuckerman to administer the plan, Engle and Libco presumably obtained substantial *de facto* control over plan investment decisions. Dardick was Engle's only limited fiduciary responsibilities does not mean that they had no responsibilities whatever. As the fiduciaries responsible for selecting and retaining their close business associates as plan administrators, Engle and Libco had a duty to monitor appropriately the administrators' actions. 29 U.S.C. §§ 1104(a)(1), 1105(a) and 1105(c). *See* RESTATEMENT (SECOND) OF TRUSTS §§ 184, 224 (1959). Engle and Libco could not abdicate their duties under ERISA merely through the device of giving their lieutenants primary responsibility for the day to day management of the trust. Engle and Libco were obliged to act with an appropriate prudence and reasonableness in overseeing Dardick's and Zuckerman's management of the Reliable Trust. *Freund v. Marshall & Ilsley Bank,* 485 F.Supp. 629, 640 (W.D.Wis.1979). *See also Shaw v. International Ass'n of Machinists and Aerospace Workers Pension Plan,* 563 F.Supp. 653, 657 (C.D.Cal.1983).

The record shows that Engle was aware of the Reliable Trust's investments in Berkeley, OSI and Hickory, and that he also knew of Dardick's role and interest in the Engle group's acquisition efforts. He presumably should have been aware that Dardick—for whose appointment he was directly responsible—faced conflicting loyalties with respect to those investments. Engle also knew of Zuckerman's ties to the Engle group. Zuckerman was president of Reliable Manufacturing, a member of its board and administrator of the Reliable Trust, but he received no compensation for any of these positions. He was paid by Engle only as a consultant to Libco and as a member of the Libco board. Zuckerman thus had substantial interests of his own in the outcome of the Engle group's acquisition efforts, and Engle knew of those interests which created conflicting loyalties for Zuckerman as administrator of the Reliable Trust.

Libco was also aware of the Reliable Trust's investments and Dardick's and Zuckerman's conflicting interests. All three members of the Reliable Manufacturing board of directors—Engle, Zuckerman and George Contarsy—were also members of Libco's board of directors. Engle was chairman of the Libco board and held a controlling interest in Libco. Libco, of course, controlled the Reliable Manufacturing board which appointed and oversaw the Reliable Trust administrators, who faced such markedly conflicting interests in managing the trust's investments. Documents filed by Libco with the Securities and Exchange Commission show that Libco knew of the Reliable Trust's investments in Berkeley, OSI and Hickory.[34]

The question thus becomes whether Engle and Libco fulfilled their duties under section 404 and section 405 in light of their knowledge that the Reliable Trust administrators who managed the trust assets faced conflicting loyalties with respect to those investments. Engle and Libco were not obliged to examine every action taken by Dardick and Zuckerman, but under these circumstances, we think that Engle and Libco were obliged to take prudent and reasonable action to determine whether the administrators were fulfilling their fiduciary obligations. Engle and Libco could not abdicate all of their responsibilities by appointing Dardick and Zuckerman, nor could they insulate themselves from all fiduciary

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personal attorney and general counsel to the business enterprises controlled by Engle—Libco, Telco, Telvest, GSC, the Bank of Lincolnwood and Sierra. Most, if not all, of his income was under Engle's direct control. Further, while the Reliable Trust was investing in Berkeley, OSI and Hickory, Dardick was at the same time assisting Engle, Libco, Telco and Telvest in their acquisition programs and litigation against the same three companies. Dardick was thoroughly aware of how the Trust's investments would affect those acquisition programs. There would have been no need for Engle to instruct Dardick about how to use the trust assets. However, plaintiffs have not shown that the district court clearly erred in finding that Engle and Libco did not exercise authority over the trust's investments in Berkeley, OSI and Hickory. But the analysis here is more properly focused on whether Engle and Libco fulfilled the duties of surveillance and oversight which stemmed from their power to select and retain the plan administrators.

[34] *See supra* notes 11, 13 and 14.

liability by limiting their roles in the administration of the trust.

Nothing in the record now before us shows that Engle or Libco took steps either to insure that Dardick and Zuckerman were fulfilling their fiduciary obligations or to remedy any violations which might have already occurred. However, because the district court's analysis of this issue was so limited, the district court should consider this issue on remand so that the parties may address themselves directly to whether Engle and Libco acted reasonably and prudently in light of their knowledge of the administrators' conflicting interests and the trust's investments. Therefore, we vacate the district court's conclusion that Engle and Libco were not fiduciaries with respect to the trust's Berkeley, Hickory and OSI investments, and we remand for further proceedings on the question of their liability as fiduciaries.

V.

[10] Plaintiffs also allege that the Reliable Trust terminated as a matter of law, either wholly or partially, in March 1979 when Reliable Manufacturing discharged seventy-five of its eighty-one employees and went into involuntary and then voluntary bankruptcy proceedings. They claim that Dardick and Zuckerman as administrators and the National Boulevard Bank as trustee breached their fiduciary duties by delaying distribution of the trust after its legal termination.

The dispute over the termination of the plan and distribution of plan assets arose only after this litigation was initiated. On February 8, 1979, plaintiffs moved in the district court for appointment of a receiver to distribute vested funds in the Reliable Trust. In early March 1979, as noted, Reliable Manufacturing went into involuntary bankruptcy proceedings, and seventy-five of its eighty-one employees were laid off. Later in March, the bankruptcy proceedings were converted to voluntary proceedings under Chapter 11. Under applicable Internal Revenue Service regulations and the terms of the Reliable Trust instruments, the plan may have terminated when Reliable Manufacturing began to discharge its employees and went into bankruptcy, and the plan beneficiaries may have been entitled to an immediate distribution of their shares in the trust. *See* Plaintiffs' Exhibits 7 and 8; 26 C.F.R. § 1.401-6 (1983). Beginning on March 1, 1979, attorneys for the Reliable Trust engaged in extended correspondence with the Internal Revenue Service seeking a determination of whether the trust had partially terminated. They described the lay-off of the seventy-five employees as "temporary" and "seasonal" in their letter to the IRS.

The district court denied the motion to appoint a receiver on May 30, 1979. Dardick and Zuckerman delayed distribution of the vested funds through the summer, saying they were waiting for the IRS to advise them. Then, on September 14, 1979, Dardick and Zuckerman asked the district court to approve a notice to be sent to plaintiff beneficiaries. The proposed notice offered the plaintiffs the following choice. First, they could receive immediate payment of all vested funds, but only if they released the defendants from all liability, including liability in this case. Second, if they did *not* release the defendants from liability, the plaintiffs would receive their vested funds only over a ten-year period, subject to an unspecified reserve. The district court denied the defendants' request, and most trust funds were distributed in 1980 in return for releases not affecting rights in this case.

The district court found that the plan administrators acted reasonably in seeking the determination from the IRS and in setting aside a substantial reserve for attorney fees, accounting and other expenses. In its findings of fact and conclusions of law, the district court did not mention the attempt to make distribution of vested funds to plaintiffs contingent on a release from liability in this case. Nor did the district court address the proper application of the Reliable Trust instruments and the Internal Revenue Service regulations concerning termination of employee benefit plans. Further, the district court appears not to have considered the effect of the clear conflict of interests that crystallized when this litigation was filed. *See supra* note 23. Finally, the district court's findings of fact and conclusions of law are inconsistent in regard to the apparently important question whether the IRS determination was sought before or after the beginning of the bankruptcy proceedings.[35] Therefore, we vacate the district court's findings with respect to the delayed distribution of the Trust and damages which plaintiffs might have suffered from the delay. On remand the district court should consider when the Reliable Trust terminated and whether Dardick, Zuckerman and the National Boulevard Bank violated their fiduciary duties by delaying distribution of the Trust after bankruptcy proceedings had begun, by seeking an IRS determination regarding the termination of the plan, and by delaying distribution while seeking to make distribution contingent on releases from liability in this lawsuit. The court should also consider whether Engle and Libco fulfilled their fiduciary duties in overseeing the administrators' actions in delaying distribution. *See supra* Part IV. In addition, the court should also consider the extent, if any, to which plaintiffs may have been damaged by the delayed distribution of plan assets.

VI.

[11] On remand the district court will face the formidable task of finding an appropriate measure of damages, if any, with regard to all defendants found to be liable as fiduciaries. Of course, the starting point for the inquiry is the language of 29 U.S.C. § 1109(a), which provides that:

> Any person who is a fiduciary with respect to a plan who breaches any of the responsibilities, obligations, or duties imposed upon fiduciaries by this subchapter shall be personally liable ... to restore to such plan any profits of such fiduciary which have been made through use of assets of the plan by the fiduciary....

Plaintiffs contend that they are entitled to *all* profits made by Engle, Libco, Telco, Telvest, Dardick and Zuckerman in their own investments in Berkeley, OSI and Hickory. The plaintiffs' argument reaches too far, for it ignores the limiting words, "made through use of assets of the plan." 29 U.S.C. § 1109(a). We believe that this language of section 1109 permits recovery of a fiduciary's profits only where there is a causal connection between the use of the plan assets and the profits made by fiduciaries on the investment of their own assets. *Cf. Brandt v. Grounds,* 687 F.2d 895, 898 (7th Cir.1982) (plaintiffs must prove causal connection between plan losses and breaches of fiduciary duty). The Reliable Trust investments in Berkeley, OSI and Hickory were relatively small in proportion to the investments made by the whole Engle group.[36] If plaintiffs were to recover all profits made by all defendants in these transactions, the recovery could double or triple the size of the trust.

On remand the district court should determine whether the profits made by each defendant found to have breached his or its fiduciary duties are attributable, in whole or in part, to the Engle group's use of the

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[35] In its Finding of Fact No. 17, the district court said the defendants acted reasonably in seeking the IRS determination *before* bankruptcy proceedings began. In its Conclusion of Law No. 14, the court concluded that the defendants' decision to seek the IRS determination *subsequent* to the beginning of bankruptcy proceedings was not arbitrary or capricious. The precise timing of these events could be decisive in light of 26 C.F.R. § 1.401-6(b)(1) (1983) and § 9.1(b) of the agreement establishing the Reliable Trust.

[36] The table below shows the investments in Berkeley, OSI and Hickory by the Reliable Trust, investments by all members of the Engle group, including the trust, on April 16, 1978, before the Telco purchases, and the maximum holdings of the Engle group in each company. Percentages are percentages of each company's total outstanding shares.

	Berkeley	OSI	Hickory
Reliable Trust holdings	0.65%	0.87%	0.57%
Engle group holdings on April 16, 1978	4.04%	1.68%	4.88%
Maximum holdings of Engle group	10.70%	21.73%	52.80%

See Short Appendix at 29–33.

trust and its assets. We recognize that in the context of a contest for corporate control, this inquiry into causation may be exceedingly difficult. Where, for example, the success and profitability of substantial minority investments depended upon the total amount of stock accumulated, it may be difficult to determine how much of the profit, if any, was attributable to the marginal increase in the group's block of shares contributed by the Reliable Trust. Also, the timing of the trust's investments may be relevant. Although the trust's investments in the three companies were small in proportion to the Engle group's total investments in the companies, the trust investments were made very early in the control contests, when it may have been particularly valuable to acquire the first shares discreetly. We offer these observations, which are, of course, speculative, by way of suggestion to the district court in unravelling an extraordinarily difficult damages issue. There may well be other important considerations which the district court will discover when the parties present evidence which explores the issue of causation.

[12] The problem of apportioning a wrongdoer's profits between those produced by his or her own legitimate efforts and those arguably resulting from his or her wrong is familiar to courts in other areas of the law. Where ERISA is silent as to how profits should be apportioned, we draw on those other areas of law for guidance. Perhaps the closest analogy is the apportionment of a copyright infringer's profits. The owner of a copyright may recover the infringer's profits, but only those attributable to the infringement and not to the infringer's own efforts and talents. *Sheldon v. Metro-Goldwyn Pictures Corp.*, 106 F.2d 45, 49 (2d Cir.1939) (L. Hand, J.), *aff'd*, 309 U.S. 390, 60 S.Ct. 681, 84 L.Ed.2d 825 (1940). Where an infringer's profits are the product of both the infringer's own efforts and the infringement, a precise calculation is virtually impossible, yet justice requires that courts make estimates. In making an estimate, because the defendants are responsible for "mingling the plaintiffs' property with their own," doubts should be resolved against the defendants so that the amount awarded "will favor the plaintiffs in every reasonable chance of error." *Sheldon, supra*, 106 F.2d at 51.[37] Patent infringement decisions under a prior statute with similar provisions requiring the disgorgement of profits took a similar approach to apportioning profits. *See Dowagiac Mfg. Co. v. Minnesota Moline Plow Co.*, 235 U.S. 641, 35 S.Ct. 221, 59 L.Ed. 398 (1915); *Westinghouse Elec. & Mfg. Co. v. Wagner Elec. & Mfg. Co.*, 225 U.S. 604, 32 S.Ct. 691, 56 L.Ed. 1222 (1912).

This case is also similar to the common law problem in which a trustee commingles trust assets with his or her own so that it is difficult to discern which property and profits belong to whom. In a suit against the trustee, the trustee has the burden of showing which property and profits are his. The trustee is responsible both for the difficulty and for resolving it. *See* 5 A. Scott, The Law Of Trusts § 515 at 3612 (3d ed. 1967); 1 G. Palmer, The Law Of Restitution § 2.13 (1978); *Grodsky v. Sipe*, 30 F.Supp. 656, 661 (E.D.Ill.1940); *Winger v. Chicago City Bank & Trust Co.*, 394 Ill. 94, 111, 67 N.E.2d 265, 277 (1946).

[13] Based on the treatment of these similar problems of apportionment, we believe that the burden is on the defendants who are found to have breached their fiduciary duties to show which profits are attributable to their own investments apart from their control of the Reliable Trust assets. It is conceivable that the defendants who have breached can show they received no benefit at all from use of the trust assets. In any event, while the district court may be able to make only a rough approximation, it should resolve doubts in favor of the plaintiffs. *Sheldon, supra,* 106 F.2d at 51.[38] This course should avoid the two unfair results of depriving defendants of the profits earned by their own efforts or depriving the plaintiffs of any recovery simply because the defendants have made it difficult to disentangle commingled profits.

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[37] When *Sheldon* was decided, the Copyright Act provided that the infringer would be liable for, among other things, "all the profits which the infringer shall have made from such infringement. . . ." 17 U.S.C. § 25(b) (1934). With respect to its causation element regarding profits, this provision is quite similar to the language of ERISA, 29 U.S.C. § 1109(a), which we apply here.

We believe that this approach to the damages in this case is also in accord with the overall purpose of ERISA and the flexible remedial powers provided in 29 U.S.C. § 1109(a). The primary purpose of ERISA is to protect the interests of plan beneficiaries, and the disgorgement requirements of section 1109(a) are intended to promote their interests by removing the fiduciary's incentives to misuse trust assets. Yet that provision would be of little value if, in cases such as this, beneficiaries confronted an insurmountable obstacle in proving the extent of a fiduciary's profits. *See Brink v. DaLesio,* 667 F.2d 420, 426 (4th Cir.1981) (burden of proof on trustee to show that prohibited transaction did not damage trust). We read section 1109(a), providing that the fiduciary "shall be subject to such other equitable or remedial relief as the court may deem appropriate," as authorizing us to cast the burden of proof on the defendants here to ensure that the disgorgement remedy is effective.

On remand, therefore, the district court should determine the extent of the defendants' profits, if any, made "through use" of the Reliable Trust assets. In doing so it must remember that the need for apportionment arose on account of defendants' breaches of their fiduciary duties. Plaintiffs must be denied a windfall but must receive the benefit of such reasonable doubts as appear.

In addition, some defendants may be liable as fiduciaries for damages resulting from delays in distribution. *See supra* Part V.

VII.

The district court also awarded costs and fees to all defendants, and it found that Dardick, Zuckerman and the National Boulevard Bank were entitled as fiduciaries to reimbursement for costs and attorneys' fees from the assets of the Reliable Trust. One law firm has represented all defendants in this case. The awards of costs and attorneys' fees to all defendants cannot stand.

[14] ERISA provides that the district court in its discretion may award attorneys' fees to any party, 29 U.S.C. § 1132(g)(1), but the court's discretion is not unbounded. The courts have developed standards for the exercise of their discretion in awarding attorneys' fees under ERISA.[39] The district court made no findings and apparently undertook no analysis that would justify an award of fees to any defendants. From the record we can discern no grounds for the district court's fee award, and therefore we would have to vacate the award to all defendants even if we were to affirm the district court's judgment on the merits. *Cf. Janowski v. International Brotherhood of Teamsters Local No. 710 Pension Fund,* 673 F.2d 931, 941 (7th Cir.1982) (upholding fee

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[38] The *Sheldon* rule was adopted in light of the common law of trusts. "[A]n infringer carries the burden of disentangling the contributions of the several factors which he has confused. The law requires him to resolve any doubts arising from his wrong; he is like any other constructive trustee." 106 F.2d at 48 (citing *Callaghan v. Myers,* 128 U.S. 617, 666, 9 S.Ct. 177, 191, 32 L.Ed. 547 (1888)).

[39] In deciding whether to award fees, the court should consider several factors, including:

> (1) The degree of the opposing parties' culpability or bad faith; (2) the ability of the opposing parties to satisfy an award of fees; (3) whether an award of fees against the opposing parties would deter others from acting under similar circumstances; (4) whether the parties requesting fees sought to benefit all participants and beneficiaries of an ERISA plan or to resolve a significant legal question regarding ERISA; and (5) the relative merits of the parties' positions.

Marquardt v. North American Car Corp., 652 F.2d 715, 717 (7th Cir.1981) (quoting *Hummell v. S.E. Rykoff & Co.,* 634 F.2d 446, 452 (9th Cir.1980)). Even where the plaintiff does not prevail on his or her claim, an award of attorneys' fees against an ERISA plaintiff will rarely be justified. *See Marquardt, supra,* 652 F.2d at 719–20.

award where basis for award could be discerned from record), *vacated on other grounds*, — U.S. —, 103 S.Ct. 3565, 77 L.Ed.2d 1406 (1983).

[15] In any event, because we hold that Dardick and Zuckerman violated their duties to administer the Reliable Trust solely in the interest of the beneficiaries, we reverse the award of fees and costs for those defendants. Where an ERISA beneficiary substantially prevails on the merits of his or her claim, an award of fees with respect to such a claim against the party in question would almost always be an abuse of discretion. *See Miles v. New York State Teamsters Conference*, 698 F.2d 593, 602 (2d Cir.) (vacating award of fees to plaintiffs where judgment for plaintiffs was reversed on appeal), *cert. denied*, — U.S. —, 104 S.Ct. 105, 78 L.Ed.2d 108 (1983); *Kemmis v. McGoldrick*, 706 F.2d 993, 997–98 (9th Cir. 1983) (vacating fee award to employer where judgment for employer was reversed on appeal).

Because we vacate the district court's conclusions that Engle, Libco and the National Boulevard Bank are not liable as fiduciaries, we also reverse the award of fees and costs to them. Plaintiffs may still show that these defendants breached their duties to the trust and its beneficiaries, so any award of fees is premature. Also, even if Engle, Libco and the bank had prevailed on the merits, the district court's failure to establish a basis for the fee award and the problems of apportionment where one firm of attorneys represents all defendants would require us to vacate the fee award to these defendants.

Plaintiffs have not prevailed on the merits against Telco and Telvest, but we must vacate the award of attorneys' fees to Telco and Telvest. As we noted above, because the district court failed to analyze the factors relevant for awarding fees under ERISA, there is no basis in the record for the award of fees to Telco and Telvest. Further, because all defendants in this case were represented by one law firm, and because we reverse the award of fees to Dardick, Zuckerman, Libco, the bank and Engle, it is now impossible to determine Telco's and Telvest's shares of the total defense costs. In any event, we question whether the factors relevant to ERISA fee awards would justify a fee award for Telco and Telvest. Therefore, we vacate this award and leave all other matters involving fee determinations—whether in favor of defendants or in favor of plaintiffs—for the district court on remand.

SUMMARY

Our treatment of the district court's findings may be summarized as follows. First, we reject the conclusion that Dardick and Zuckerman did not violate their fiduciary duty to act solely in the interests of plan beneficiaries and find to the contrary. We hold that as a matter of law, the investments in OSI, Berkeley and Hickory were not made for the exclusive benefit of the plan beneficiaries. We also vacate the district court's conclusion that Engle and Libco were not liable as fiduciaries with respect to the investments and leave further fact-finding in this respect to the district court.

With regard to the delayed distribution of remaining plan assets, we vacate the district court's findings that the delays were reasonable and did not injure the plaintiffs. On remand the district court should consider whether the delays were proper and whether plaintiffs were damaged in any way by the delayed distribution of their vested funds in the trust. The court should also consider whether Engle and Libco fulfilled their duties with regard to the delayed distribution. In addition, the district court should consider at the first opportunity the desirability of an immediate distribution of all remaining assets in the Reliable Trust.

We reverse the district court's award of attorneys' fees and costs to Dardick, Zuckerman, Engle, Libco and the National Boulevard Bank. We vacate the fee awards to Telco and Telvest. Finally, the district court on remand will need to consider the question of damages with respect to each defendant found to have violated the fiduciary duties imposed by ERISA.

VACATED AND REMANDED.

U.S. Department of Labor

Labor-Management Services Administration
Washington, D.C. 20216

Reply to the Attention of:

APR 30 1984

John Welch, Esq.
Randall Bassett, Esq.
Latham & Watkins
555 South Flower Street
Los Angeles, CA 90071-2466

Re: Profit-Sharing Retirement Income Plan for the
Employees of Carter Hawley Hale Stores, Inc. (CHH)

Gentlemen:

As you know this Department has undertaken a review of the facts and circumstances surrounding the activities of, among others, the Bank of America, N.T. & S.A. (the Bank), as trustee of the above-captioned plan. Specifically, among the purposes of the review is to determine whether the Bank is properly discharging its fiduciary responsibilities to the participants and beneficiaries of the plan under applicable provisions of the Employee Retirement Income Security Act of 1974 (ERISA) in connection with the pending tender offer by The Limited, Inc. for shares of stock of CHH.

Since, at this time, we are continuing our examination of this matter, we are not prepared to state that violations of ERISA have or have not occurred. We believe, however, that in view of the fluid situation regarding the tender offer and our overriding concern that the protective provisions of ERISA be applied to prevent abuse to the Plan, you would be interested in knowing the Department's opinion as to the general obligations of plan trustees, such as the Bank, in tender offer situations where specific plan provisions purport to limit the trustees responsibilities and obligations.

In the case of an eligible individual account plan holding employer securities, a procedure for obtaining instructions from participants with regard to the decision whether to tender shares of such securities allocated to their accounts in response to a tender offer could, in our view, be lawfully put into effect under section 403(a)(1) of ERISA only in certain limited situations where the instructions received by the trustee of the plan are proper and not contrary to ERISA. Under section 404(a)(1)(D), however, if the plan documents or instruments prescribe a course of action which in a particular situation is not consistent with Title I or IV of ERISA, the trustee cannot engage in that action.

Situations where a procedure for obtaining instructions from participants could lawfully be put into effect would occur only when the trustee had determined that the participants had in fact rendered an independent decision in directing the trustee, without pressure from their employer as to how to vote their shares. Therefore, the trustees would remain responsible for such matters as assuring that the plan's provisions are fairly implemented, that necessary information is provided to participants, that clearly false or misleading information is not distributed to participants (or to correct any such false or misleading information that may have been distributed to participants by other parties) and would also remain responsible for determining whether following participant directions would result in a violation of Title I of ERISA. In our view, therefore, if, among other things, the participants-employees are subjected to pressure from the employer to vote their shares in a particular manner, it would be the duty of the trustee to ignore any direction given which is the result of such pressure, as it could not be considered "proper direction."

We would also like to specifically point out that, in our view, an affirmative direction from a participant is necessary for section 403(a)(1) to apply. Thus, for example, a trustee cannot rely on a plan provision requiring that participants who do not specifically provide instructions be deemed to have issued a specific instruction regarding the tender of the shares allocated to their accounts. Furthermore, under ERISA, a trustee may not give effect to a participant's direction insofar as it purports to require reversal of the direction in order to conform with the directions of the majority of plan participants.

We also believe that the fiduciary duties of ERISA would require the trustee to consider whether the Plan has any claims under ERISA, the securities laws, or other law arising from the conduct of any party in connection with the tender offer, and, if appropriate, to take action to assert those claims.

Of course, in this case, as in all matters, trustees must ascertain whether existing or potential conflicts of interest may interfere with the proper exercise of these responsibilities.

We hope this information will be useful to you in advising your client respecting carrying out its fiduciary responsibilities to the plan. Your cooperation during our continuing examination is appreciated.

Sincerely,

Robert A.G. Monks
Administrator
Office of Pension and Welfare
Benefit Programs

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JAMES H. SAMMONS, M.D.
Executive Vice President
(645-4300)

July 1, 1985

The Honorable William S. Cohen
Chairman
Subcommittee on Oversight of Government Management
Committee on Government Affairs
U.S. Senate
Washington, D.C. 20510

RE: Oversight of the Employee
Retirement Income Security Act
(ERISA)

Dear Senator Cohen:

Enclosed please find the statement of the American Medical Association concerning the Employee Retirement Income Security Act (ERISA). We request that this statement be made a part of the record of the hearings held on June 25 and 26, 1985.

We believe that the ERISA preemption of appropriate state regulation of self-funded health plans is an important and growing problem. Draft legislation which we have developed and attached to our statement will overcome this regulatory dilemma. We urge the Subcommittee to endorse this legislation.

Sincerely,

James H. Sammons, M.D.

JHS/ss
Enclosure

1983p

STATEMENT

of the

AMERICAN MEDICAL ASSOCIATION

to the

Subcommittee on Oversight of Government Management
Committee on Government Affairs
U.S. Senate

RE: ERISA Oversight

July 1, 1985

The American Medical Association takes this opportunity to submit its comments on the subject of the Employee Retirement Income Security Act (ERISA). In this statement, we will primarily discuss the impact of ERISA insofar as it currently preempts state regulation of certain health benefit plans, leaving beneficiaries without proper protection. This statement contains the amendments recommended to provide such protection and we urge their adoption.

INTRODUCTION

The primary concern of the American Medical Association with the current ERISA law relates to a legal/legislative technicality that exists in the administration of ERISA with respect to employers who develop self-funded trusts to fund health care benefit plans for their employees. Specifically, we are concerned about the ERISA preemption of appropriate state regulation concerning certain employee health benefit plans.

SELF-FUNDED BENEFIT PLANS

As the cost of health care has risen in recent years, many employers have sought to reduce their expenditures for employee health benefits. One method that is becoming increasingly prevalent is for business to self-fund employee health plans. Self-funding is a program for providing group coverage with benefits financed entirely through the internal resources of the employer, in place of purchasing insurance from commercial carriers or Blue Cross/Blue Shield.

Self-funding is a rapidly growing phenomenon. According to surveys conducted by the International Foundation of Employee Benefit Plans, the percentage of employer-sponsored health plans that are fully self-funded has grown from 30% in 1979 to 50.6% in 1983. The number of fully insured plans (where underwriting risk is assumed by the carrier) has declined from 45% in 1979 to only 21.5% in 1983. In each year, the remainder of plans were partially insured (e.g., minimum premium payment plans).

The American Medical Association supports a pluralistic approach to health care financing and delivery and recognizes employer self-funded health insurance plans as one among many means of providing health benefits to employees. We do believe, however, that when businesses self-fund, employee-participants should enjoy the basic legal protections of employees covered by group health insurance plans and that such self-funded trusts should have certain basic obligations under state law as do other health insurance plans.

ERISA AND SELF-FUNDED PLANS--A REGULATORY GAP

The Employee Retirement Income Security Act of 1974 (ERISA) supersedes or preempts all state laws relating to employee benefit plans except for insurance, banking and securities regulation laws. The law also states that employee benefit plans operated by an employer cannot be deemed to be insurance, banking or securities business in order to come under state regulation. Unlike employer cash pension plans, which are closely regulated by the federal government, controls have not been established at the federal level specifically concerning employer provided health benefit plans. This arrangement has led to problems, with self-funded health benefit plans escaping appropriate regulation due to the broad preempting language of federal law and an absence of federal regulation.

Three years ago this regulatory gap first became a major public policy problem with the widely publicized failures throughout the country of a number of self-funded "multiple-employer trusts", or "METs", leaving in their wake thousands of beneficiaries with unpaid medical and hospital bills.

Congress responded to this problem by including language in Public Law 97-473, enacted January 14, 1983, which allows state regulation of "Multiple Employer Welfare Arrangements." P.L. 97-473 exempts from the ERISA preemption any state laws that require multiple employer welfare arrangements (METs) to maintain specified levels of reserves and contributions.

The AMA supported the enactment of P.L. 97-473. However, we believe that insurance regulatory problems continue to exist which warrant further limiting of ERISA preemption of state laws.

NEED FOR AMENDING ERISA

The American Medical Association believes that with the fast-growing proportion of workers receiving health benefit coverage through self-funded mechanisms it becomes more and more important that states be given the authority to subject such plans to specific portions of appropriate state insurance laws. Several important reasons exist for treating self-funded plans in similar fashion as other group health insurance:

- protection of individual beneficiaries through imposition of state solvency standards,
- strengthening the effectiveness of state risk pooling mechanisms,
- assurance of delivery of quality health care, and
- assuring access to participation in plans by health care providers.

The regulation of the business of insurance has been primarily a responsibility of state legislatures over the years. ERISA is a notable exception to this area of state-oriented public policy. The American Medical Association has always supported and continues to support a regulatory environment for health insurance focused at the state level. We believe that each state should determine its own response to the varying needs for protection of its citizens.

Protection of Individuals. Provisions of state insurance codes requiring specified levels of capitalization and reserves were enacted in order to provide policyholders and beneficiaries with fundamental assurances that their insurance would be available when they needed it. This system has worked quite well with each state establishing standards designed to meet its needs and conditions. The growing number of persons covered by health plans that are not governed by these consumer protection laws, however, undermines the public benefit served by such state legislative safeguards. The American Medical Association believes that all workers should be entitled to the same safeguards under state insurance laws and that such safeguards should not be dependent upon whether the beneficiaries are enrolled in a regulated group insurance plan or an unregulated self-funded plan.

State Risk Pooling for Health Insurance. Reliable estimates indicate that nearly one million persons are unable to obtain insurance in the private market because of medical problems. While this number is small in proportion to the general population, in our view, it represents a significant social problem.

Seven states have legislation creating or authorizing a risk-sharing or reinsurance association to offer health insurance at a reasonable cost to persons who are high-risk or "uninsurable" by conventional underwriting standards. While some of these laws provide that self-insurers are to participate in the risk-sharing association, the states are effectively precluded by ERISA from enforcing such a requirement. We believe that the problem of providing coverage for medically uninsurable persons is of sufficient dimension to merit enactment of state legislation requiring special efforts for coverage of this group in every state.

In our view all health care financing entities in a state should be required to participate in such pooling arrangements. Such programs providing coverage for this group benefit all citizens within a state. Such programs can be financially viable only if participation by all health care financing entities, including commercial insurers, non-profit medical or hospital service plans, HMOs and self-funded groups, is required.

Only with such uniform participation can adverse selection be avoided and a financial base sufficient to support the program be assured. Participation of self-funded groups in such a state program cannot be required at present because of the preemption in ERISA against any state-level regulation of self-funded groups. This should be changed.

Quality of Care Concerns. Some states are beginning to develop health plan regulations to help assure the delivery of high quality care in health plans. For example, California law provides, among other things, that contracts with group policy holders "shall include programs for the continuous review of the quality of care, performance of medical personnel, utilization of services and facilities and costs, by professionally recognized unrelated third parties." These requirements are not applicable to self-funded entities due to the ERISA "regulatory gap." We believe that ERISA should be amended to provide that any state law provisions designed to provide quality of care assurances should be applicable to self-funded health plans in that state.

Accessibility of Providers. Present state laws regulating insurance plans as to accessibility of providers vary significantly. Many states have laws designed to assure freedom of choice of provider and payment for services rendered by such providers. However, these laws are not applicable to self-funded plans due to the ERISA exemption. Based on an analysis we have conducted of relevant statutes, it would appear quite possible that, in many if not most states, applicable state legislation generally would not prohibit nonprofit service plans from marketing contracts which would refuse payment entirely for services rendered by non-participating providers. While commercial insurance companies are on the whole still subject to relatively stringent state prohibitions against any contractual restriction in the subscribers' freedom of choice, there appears to be relatively little statutory impediment to nonprofit medical service plans making no payment to either patient or physician for services provided by non-participating physicians.

AMA DRAFT FEDERAL LEGISLATION

The AMA has developed draft federal legislation to amend ERISA so that states may exercise certain regulatory authority over self-funded plans. The draft bill would create additional exemptions to the general rule of ERISA preemption of state laws. The new exceptions would provide that state insurance laws could apply in the case of an employee welfare benefit plan (i.e., a self-funded employer's plan) established for the purpose of providing medical, surgical, or hospital care or benefits, to the extent that the state law provides for standards requiring the maintenance of specified levels of reserves and contributions, participation in health insurance risk pools, requirements for the quality of health care provided through such a plan, requirements to assure access to participation by health care providers, and provisions to enforce such standards. A copy of our draft legislation is attached to this statement.

CONCLUSION

The American Medical Association urges the Subcommittee to adopt our draft bill to amend ERISA to permit the states to exercise appropriate regulation of a growing segment of the group health benefit market.

1824p

January, 1985

ERISA AMENDMENT RE: STATE REGULATION OF SELF INSUREDS

This bill would create exceptions to the general rule in ERISA (the Employees Retirement Income Security Act of 1974) which provides that ERISA supersedes all state laws relating to employee benefit plans except for insurance, banking and securities regulation laws. The law also states that employee benefit plans operated by an employer cannot be deemed to be insurance, banking or securities businesses. The exceptions created in the draft bill would provide that a self-insured employer's plan would be subject to state insurance laws in the case of an employee welfare benefit plan established for the purpose of providing medical, surgical, or hospital care or benefits, to the extent that the law provides for standards requiring the maintenance of specified levels of reserves and contributions, participation in health insurance risk pools, regulation of accessibility of providers and quality of care, and provisions to enforce such standards.

The need for this legislation arises from the problems created by the ERISA pre-emption of state laws, specifically, the lack of appropriate governmental regulation at either the state or federal level of solvency requirements and other fundamental public interest safeguards routinely required of other entities providing health insurance protection.

- American Medical Association -

Department of Federal Legislation, Division of Legislative Activities

99th Congress
1st Session

Draft

Bill No. ____

IN THE (SENATE)(HOUSE) OF THE UNITED STATES

Date __________

________ of _______ introduced the following bill;
which was read twice and referred
to the ________________ Committee

A BILL

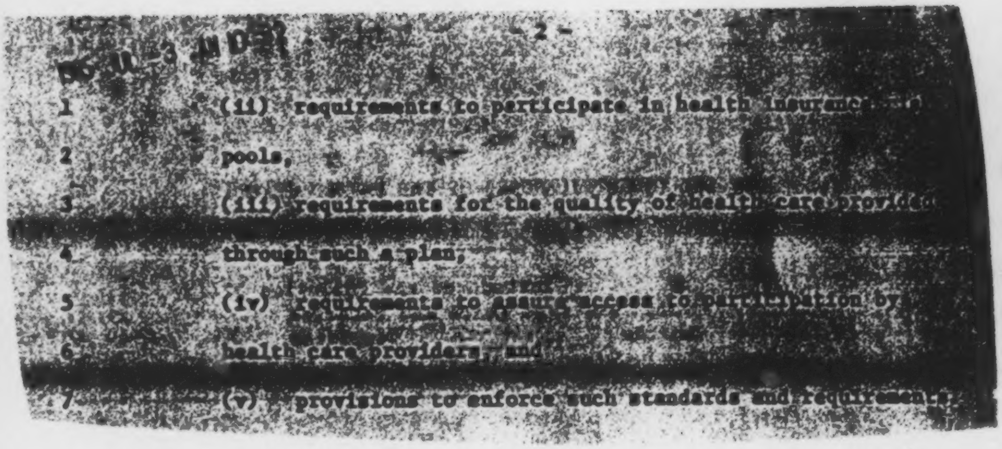
To amend the Employee Retirement Income Security Act of 1974 to define the extent to which State laws are preempted by such Act with respect to employee welfare benefit plans which provide health care benefits.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

Section 514 of the Employee Retirement Income Security Act of 1974 (29 U.S.C. 1144) is amended by deleting the period at the end of subparagraph (b)(2)(B) and inserting in lieu thereof the following:

", except that in the case of an employee welfare benefit plan established for the purpose of providing medical, surgical, or hospital care or benefits, or any trust established under such a plan, any law of any State which regulates insurance may apply to such plan to the extent that such law provides—

(i) standards, requiring the maintenance of specified levels of reserves and specified levels of contributions, which any such plan, or any trust established under such a plan, must meet in order to be considered under such law able to pay benefits in full when due,



(ii) requirements to participate in health insurance pools,

(iii) requirements for the quality of health care provided through such a plan,

(iv) requirements to assure access to participation by health care providers, and

(v) provisions to enforce such standards and requirements.

WILLIAM V. ROTH, JR., DELAWARE, CHAIRMAN

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United States Senate

COMMITTEE ON
GOVERNMENTAL AFFAIRS
SUBCOMMITTEE ON
OVERSIGHT OF GOVERNMENT MANAGEMENT
WASHINGTON, DC 20510

[illegible]
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CARL LEVIN, MICHIGAN
LAWTON CHILES, FLORIDA

SUSAN M. COLLINS, STAFF DIRECTOR

August 5, 1985

Dear

As you know, the Senate Subcommittee on Oversight of Government Management is investigating the Department of Labor's implementation of its responsibilities under the Employee Retirement Income Security Act of 1974 (ERISA) with regard to pension plans. This investigation, which included two days of oversight hearings in June, is focusing on the Department's enforcement efforts, the prohibited transaction process, and the Department's implementation of the reporting and disclosure requirements under Title I of ERISA. The Subcommittee is also exploring the Department's enforcement of the fiduciary responsibilities under ERISA, particularly with respect to corporate governance issues.

At the Subcommittee's June hearings, the Association of Private Pension and Welfare Plans testified on behalf of plan sponsors. The Subcommittee now is soliciting additional views from several individual plan sponsors to assist it in formulating its recommendations to the Congress on how to improve the implementation of ERISA. Accordingly, I invite you to provide me with your views on the following issues:

(1) Do you believe that the prohibited transaction exemption process implemented by the Office of Pension and Welfare Benefit Programs pursuant to section 408 of ERISA works well? Specifically, what has been your experience in filing applications for exemptions, and

does the process, in your view, inhibit investment opportunities? What recommendations, if any, do you have for revising the exemption process?

(2) What are your views on the 5500 series reports that pension plans must file with the Internal Revenue Service? For example, how much time is spent by your plan in filing the report? Do you believe that the information on the form is useful to the Department of Labor in detecting violations of ERISA? Do you have any recommendations for revising the reporting system?

(3) What are your views on the quality of the Department of Labor's implementation of ERISA? Do you believe that the DOL is adequately enforcing the fiduciary obligations set forth in ERISA? Is the Department providing sufficient guidance to fiduciaries on how to fulfill their responsibilities under the law? If not, in what areas should the DOL issue additional guidance?

(4) Do you think that some ERISA fiduciaries face conflicts of interest in voting stock held by pension funds and in making investment decisions on behalf of the plans? Do you think that these conflicts of interest can result in violations of ERISA?

(5) What policies and procedures, if any, do you think are necessary or desirable for institutional investors to follow in voting stock held in pension fund accounts to resolve conflict-of-interest problems?

(6) What are your views on the use of pension funds either offensively or defensively in corporate takeovers? Do you think that restrictions should be placed on the use of pension assets for such purposes? Do you have any recommendations on procedures that should be followed to ensure that the interests of plan participants and beneficiaries are adequately protected during a corporate takeover bid?

August 5, 1985
Page Three

It also would be useful to the Subcommittee if you would provide the following background information concerning your plan(s):

(1) Please describe the type, amount of assets, and number of participants and current beneficiaries of your pension plan(s).

(2) What process do you follow in making investment decisions for your plan? Does your plan have in-house investment managers? Do you contract with outside investment managers?

(3) What procedures do you follow in assessing or monitoring the investment performance of the investment managers handling your pension funds?

(4) What procedures do you follow in exercising the voting rights of stock held by your pension funds? For example, do you, as the plan sponsor, exercise the voting rights or are these responsibilities delegated to investment managers?

I appreciate your assistance to the Subcommittee in its evaluation of these issues. Please send your response to the Subcommittee on Oversight of Government Management, Room 326 Dirksen Senate Office Building, Washington, D.C. 20510, by August 26. If you have any questions, please contact Kim Corthell or Mary Gerwin or the Subcommittee staff at (202) 224-5538.

With best wishes, I am

Sincerely,

Bill Cohen

William S. Cohen
Chairman

WSC:mbg

AT&T

Robert E. Angelica
Director - Pension Investments

Room 29-1728
550 Madison Avenue
New York, NY 10022
Phone (212) 605-7145

September 5, 1985

The Honorable William S. Cohen
Subcommittee on Oversight of Government Management
Dirksen Senate Office Building
Room 326
Washington, D.C. 20510

Dear Senator Cohen:

We wish to thank you and the other members of the Senate Subcommittee on Oversight of Government Management for this opportunity to present our views regarding the Department of Labor's implementation of its responsibilities under the Employee Retirement Income Security Act of 1974 (ERISA).

As a general statement, we feel that the Department of Labor, despite a chronic shortage of adequate resources, has done a credible job of implementing and enforcing the provisions of ERISA, thereby contributing to the noteworthy success of the private pension system in the United States. Nevertheless, there is room for improvement. Following are our responses to the detailed issues you raise. Our answers are numbered to correspond to your questions:

1. The prohibited transaction exemption process works much too slowly. We have found the Department to be cooperative and responsive to exemption requests, but overburdened and therefore often times not able to respond in a timely fashion. Additionally, the process itself necessitates, at a minimum, approximately four months from filing to grant, assuming the process was to work absolutely smoothly in a particular case. Most exemptions take anywhere from 6 to 12 months. As you know, many investment transactions cannot await such administrative delays. Perhaps the prohibited transaction provisions could be streamlined if technical prohibited transaction problems (i.e. those not involving conflicts of interest) under ERISA Section 406(a) were eliminated. This would mean that the only prohibited transactions would be true conflicts of interest under Section 406(b). Also, perhaps an alternative standard of an "arms-length" test could be used. Finally, more class exemptions could be issued covering standard types of transactions.

2. AT&T views the filing of the annual IRS Form 5500 an extremely burdensome administrative task. The Investment Management Division of AT&T devotes the efforts of the equivalent of one full time employee for approximately 4 to 5 months each year to collect, analyze and complete this form. In addition, other employees in our legal, personnel and actuarial sciences groups also devote substantial efforts in fulfilling AT&T's 5500 filing requirements.

   The 5500 annual report forms are not that helpful in uncovering many prohibited transactions or other violations of ERISA in that if the violations are inadvertent they may not be depicted at all on the form and if they are intentional, presumably the violating fiduciary is not going to report it. Perhaps the reporting system could be streamlined by providing that reports need only be filed tri-annually, except that major changes or extremely significant transactions could be reported on a more frequent basis.

3. As stated above, the Department of Labor has done a reasonable and professional job in enforcing and interpreting ERISA. For example, we have found the Department to be responsive in meeting informational requests seeking interpretations or clarifications of ERISA provisions and their application. However, increased guidance could be provided in the following areas: investments in commingled funds (i.e., the "plan asset" issue); incentive compensation; soft dollar/directed brokerage; and self-directed accounts. This lack of guidance, in turn, obviously stems from presently limited department resources and personnel.

4. Overall, we do not believe that ERISA fiduciaries face any greater conflicts in voting stock than they do in making other investment-related decisions. We are not aware of any ongoing pattern of violations in the voting of stock or in other areas. We believe that this area should be addressed by plan fiduciaries in the same manner as other investment and fiduciary-related decisions. ERISA holds such fiduciaries accountable to a high standard of performance with strong legal remedies in place if they fail to comply.

5. AT&T believes that institutional investors should develop clearly defined policies and, to the extent possible, specific guidelines for dealing with proxy matters. Each issue coming before stockholders should then be considered on its individual merits and analyzed to determine whether or not it is in the ultimate economic interest of plan participants.

6. Obviously, pension plan assets should not be used for the purpose of either providing an offense or a defense in a corporate takeover situation. I emphasize the words "for the purpose of." The funds should always be directed to the exclusive benefit of the plan participants, which in some cases will support a corporate takeover and in other cases presumably would not. I believe that prevailing market conditions and independent fiduciary decisions regarding tender offers provide adequate protections to participants without the need for further legislation or other regulation.

The following is the background information you requested concerning our plans:

1. AT&T has two pension plans for its employees. The AT&T Management Pension Plan is a defined benefit pension plan (fixed benefit) which covers primarily eligible management and salaried employees. The AT&T Pension Plan is a defined benefit pension plan (unit benefit) which covers eligible employees in bargaining units represented by unions and non-represented employees in similar job titles or classifications. At year end 1984, the combined market value of the assets of the plans (held in the AT&T Master Pension Trust) was $19 billion and was approximately equally divided between the two plans. There are approximately 132,000 participants in the management plan and 284,000 participants in the non-management plan.

2. The investment responsibilities of the Investment Management Division of AT&T complement the responsibilities of the AT&T Master Pension Trust's external investment managers. The principal task of the company's outside managers is to add value beyond a market return within their assigned role in the aggregate Trust. IMD's responsibility is to develop and implement broad policy with respect to the overall structure of the Trust; exercise in-house responsibility for a portion of the Trust's assets in order to provide a market return at minimum cost; and select and monitor external investment managers.

3. AT&T monitors the performance of its investment managers informally on a continous basis and formally at regularly scheduled semi-annual investment review meetings. Our approach is to compare the 3-5 year performance of the manager with those of other similar managers and with appropriate indices using various statistical analysis tools.

4. For all pension assets managed by outside investment managers, AT&T's current policy is to grant such managers full discretion to vote proxies for shares under their control as they see fit. However, the company requires that all pension managers vote proxies solely in the economic interests of the plan's participants and beneficiaries. In regard to in-house managed passive assets, AT&T currently delegates its proxy voting authority to an independent custodian subject to certain broad policy directives and specific guidelines developed by AT&T. The custodian's voting record is reviewed quarterly to determine adherence to AT&T's policies.

We hope you find our responses useful. If we can be of further assistance, please contact Katherine Hagen on (202) 457-3838.

Sincerely,

Robert E. Angelica

1985 SEP 16 PM 10: 50

Amoco Corporation
200 East Randolph Drive
Post Office Box 5910A
Chicago, Illinois 60680
312-856-2945

P.W. Binzel
Assistant Treasurer Investments

September 12, 1985

The Honorable William S. Cohen, Chairman
Subcommittee on Oversight of Government Management
Room 326 Dirksen Senate Office Building
Washington, D.C. 20510

Dear Senator Cohen:

Your letter of August 5, 1985, invited my views on issues relating to the Senate Subcommittee on Oversight of Government Management's investigation of the Department of Labor's implementation of its responsibilities under ERISA with regard to pension plans. My views follow.

Issue: Do you believe that the prohibited transaction exemption process implemented by the Office of Pension and Welfare Benefit Programs pursuant to section 408 of ERISA works well? Specifically, what has been your experience in filing applications for exemptions, and does the process, in your view, inhibit investment opportunities? What recommendations, if any, do you have for revising the exemption process?

View: Although our Trust has never filed for a prohibited transaction exemption (choosing instead to rely upon class exemptions granted by the DOL or to avoid investments which might be viewed as prohibited transactions), we have been advised by outside counsel that the exemption process is time consuming. That element may inhibit investment opportunities.

Issue: What are your views on the 5500 series reports that pension plans must file with the Internal Revenue Service? For example, how much time is spent by your plan in filing the report? Do you believe that the information on the form is useful to the Department of Labor in detecting violations of ERISA? Do you have any recommendations for revising the reporting system?

View: Amoco spends approximately 30 manweeks in the preparation of about 60 Form 5500's. Approximately 20 to 25 relate to the pension plans with an average time devoted of about 15 to 20 manweeks. During preparation time, there is a feeling that our efforts are wasted due to the general belief that neither the IRS nor the DOL will ever review the reports.

We believe that the volume of information requested makes it very difficult for a regulatory agency to sort and analyze data, and offer the following recommendations to revise the reporting system:

1. Eliminate the need for filing a 5500 for insured non-contributory welfare benefit plans. While this does not relate to the pension plan issue, eliminating this group of 5500s (which constitute more than 50% of Amoco's filings) would greatly reduce the amount of information to be reviewed.

2. Reconsider the current threshold of 100 participants as being the cut-off for filing a Form 5500. A criteria other than the number of participants should also be considered, i.e. total value of assets, types of pension fund investments, plan funding status, etc.

3. The information requirements should be cut in half and designed to elicit direct response on prohibited transactions and conflict-of-interest issues.

Issue: What are your views on the quality of the Department of Labor's implementation of ERISA? Do you believe that the DOL is adequately enforcing the fiduciary obligations set forth in ERISA? Is the Department providing sufficient guidance to fiduciaries on how to fulfill their responsibilities under the law? If not, in what areas should the DOL issue additional guidance?

View: The DOL has recently issued proposals, relating to venture capital and other partnership investments' status as "plan assets," which appear to realistically address many business concerns while still protecting participants. However, prior to the issuance of this proposal, all plan fiduciaries were forced to evaluate these investment opportunities without legal certainty of their status under ERISA. This resulted from the existence of conflicting DOL proposals, which had not been withdrawn, and the absence of full "grandfather" protection. We would suggest that, in the future, if circumstances prevent the DOL from acting promptly to implement proposals relating to investments, the proposal should be withdrawn or explicit advice provided on the status of investments made in reliance upon (i) the prior law, or (ii) the proposal. We believe it is not equitable to force a fiduciary to bear the risk of this type of legal uncertainty.

Issue: Do you think that some ERISA fiduciaries face conflicts of interest in voting stock held by pension funds and in making investment decisions on behalf of the plans? Do you think that these conflicts of interest can result in violations of ERISA?

View: This has not been a problem for our Trust. Insofaras other trusts are concerned, I do not feel qualified to comment.

Issue: What policies and procedures, if any, do you think are necessary or desirable for institutional investors to follow in voting stock held in pension fund accounts to resolve conflict-of-interest problems?

View: If stock is voted in accordance with Sec. 404(a)(1) of ERISA, I do not see how a conflict-of-interest problem can evolve.

Issue: What are your views on the use of pension funds either offensively or defensively in corporate takeovers? Do you think that restrictions should be placed on the use of pension assets for such purposes? Do you have any recommendations on procedures that should be followed to ensure that the interests of plan participants and beneficiaries are adequately protected during a corporate takeover bid?

View: I do not have any specific comments or proposals regarding this issue.

The requested background information on Amoco's pension plans follows:

(1) Describe the type, amount of assets and number of participants and current beneficiaries of your pension plans.

Amoco administered nineteen defined benefit plans in 1984. Benefits are provided from the Master Trust for Employee Pension Plans and partially from insurance contracts. Each plan participating in the Master Trust had an undivided interest in the assets and transactions. At December 31, 1984, the value of the assets of the nineteen defined benefit plans totalled $1.743 billion. There were approximately 75,000 participants of which 62% were active, 27% retired, 2% beneficiaries of deceased participants, and 9% deferred participants awaiting retirement.

Amoco administered two defined contribution "savings" plans in 1984. Benefits under the plans are provided by two trust funds. At December 31, 1984, the value of assets totalled $1.268 billion. A total of 32,197 persons were participants in, or beneficiaries of, the plans although not all of these persons had yet earned the right to receive benefits.

Amoco also administered a defined contribution "employee stock ownership" plan. Benefits under the plan are provided by a trust fund. At December 31, 1984, the value of assets totalled $178 million. A total of 47,531 employees and former employees participated in the plan. Seventy-seven percent of the employees eligible in 1982 participated in the contributory provisions of the plan in 1984. Benefits are payable only on retirement or termination of employment.

(2) What process do you follow in making investment decisions? Does your plan have in-house investment managers? Do you contract with outside managers?

Investment decisions in the defined contribution (employee savings) plans are made by participating employees. Investment decisions in the defined benefit plans are the responsibility of Amoco's Investment Committee. This committee of senior financial executives has been delegated the responsibility for the investment of pension assets that are managed in-house, and the supervision and coordination of 14 outside managers.

The establishment of asset mix guidelines has been viewed by Amoco as a primary tool in meeting its fiduciary responsibilities. The Investment Committee has undertaken its individual and aggregate asset mix and funding decisions with a view towards generating, over time, a real return on investment with minimal fluctuations in the ratio of pension fund assets to pension fund liabilities.

Our in-house management of pension assets is guided by the goal of maximizing return on assets, and at the same time minimizing the risk of losses.

Outside managers are utilized and are selected on the basis of their expertise and performance, and their investment focus in order that efforts of all managers when combined will satisfy the overall asset mix and diversification guidelines established by the Investment Committee. Outside managers are given sole discretion in the selection of investments with the only restriction being the purchase of Amoco Corporation securities or real property.

(3) What procedures do you follow in assessing or monitoring investment performance of the investment managers handling your pension funds?

Our monitoring of each investment manager account includes the accurate accounting for all transactions, summarization and measurement of results, attribution against appropriate benchmarks and guidelines, and analysis of results. The internal rate of return is calculated for each investment manager account and for each asset category within the account. These returns are compared against customized benchmarks appropriate to the manager's investment style.

(4) What procedures do you follow in exercising the voting rights of stock held by your pension funds?

In the case of the defined benefit plans, the voting rights for securities managed internally are administered by the Investment Committee through in-house analysts whose objective is maximization of portfolio return for the benefit of plan participants. The voting rights for stock held by our outside investment managers are delegated to them, and again, exercised with the same objective. The voting rights of the company stock in the defined contribution plans rest with the individual participating employees.

I am happy to assist the Subcommittee in its evaluation of these issues. If any of my responses are not clear, your staff should feel free to contact me at (312)856-2945.

Sincerely,

RW Binzel

GENERAL MOTORS CORPORATION
767 FIFTH AVENUE
NEW YORK, N.Y.

1985 OCT 29 AM 2:30

W. GORDON BINNS, JR.
CHIEF INVESTMENT
FUNDS OFFICER

October 23, 1985

1 28 1985

Senator William S. Cohen
Chairman
United States Senate
Committee on Governmental Affairs
Subcommittee on Oversight of Government Management
Washington, DC 20510

Dear Senator Cohen:

Thank you for the opportunity to provide you and your colleagues with some of our views of how to improve the implementation of ERISA. The following paragraphs respond to several of the issues cited in your letter of August 5, 1985 to R. Charles Tschampion of my staff.

(1) Prohibited transaction exemption process:

The prohibited transaction process is somewhat unwieldy, thus lengthening the time required to obtain an exemption. These delays can inhibit investment opportunity since, given a choice between dealing with a party unencumbered by a need to obtain an exemption and another party who would be required to obtain an exemption, the entity offering the investment generally would prefer to deal with the unencumbered party. In addition, the legal and other costs involved in processing these requests are substantial.

A possible alternative would be that a request for an exemption be automatically granted at the end of a reasonable waiting period (perhaps 30 days) after filing of an exception request unless the DOL advised the sponsor to the contrary prior thereto.

For a large organization such as General Motors which has plants and facilities in hundreds of locations, another difficulty with the exemption process is the need to post notices in all locations when an exemption is sought. Such notices, dealing as they do with technicalities, also can be confusing to employes.

As an example, in 1982 an investment manager of the GM Funds purchased for the plan an office building in a Rocky Mountain area which had as a small tenant an office of a major national retail brokerage firm which was a "service provider" -- as defined by ERISA -- to the plans. As this was technically a "prohibited transaction," although no possibility of conflict of interest was presented, an exemption was applied for and notices were posted. While this generated a number of comments regarding the need for posting, to our knowledge no one raised a question with DOL and no one, either within GM or within DOL, objected to the investment being made. We suggest that a posted notice in a case of this sort probably serves no useful purpose and could be eliminated. (If, however, an after-the-fact disclosure is considered helpful, this might be accomplished through the filing of Form 5500.)

(2) 5500 Reports

Preparation of the 5500 report for the GM pension assets (especially questions 13 and 14 thereof) is completed in a four month period. Completion of the form requires the efforts of 2 employes of my staff and 2 employes of our outside auditors. We could not, in the time subsequent to receipt of your letter, calculate the actual hours of employe time expended in completing these reports, but will try to do so in the next report preparation period. In addition, several other 5500 reports covering other benefit plans are prepared by members of other GM staffs.

We recommend that consideration be given to streamlining the 5500 -- we believe that some of the information required is too detailed for the purposes of disclosure and the level of detail required is time-consuming for a sponsor to produce.

The listing of the holdings of the fund at specific times appears to have little value, especially for publicly traded stocks and bonds. We recommend that such issues be aggregated and listed as "Publicly traded securities of companies which file 10K reports with the SEC."

As an additional suggestion, while we can understand the general purpose of requiring a sponsor to disclose the investment managers of its assets, it should in turn be noted that for funds such as General Motors which have most of the assets managed by external firms, the effect of this disclosure could be to reveal the plan's investment strategies because certain managers are known to specialize in certain types of assets or particular strategies. This could thus put that plan at a strategic disadvantage as compared with, for example, a fund which is totally internally managed.

Finally, with regard to the effectiveness of the information in Form 5500 in detecting violations of ERISA, it is our opinion that the actual data probably do not help very much -- it would be very surprising to see a filing that showed prohibited transactions or an excess position in employer securities, to cite two examples. On the other hand, as with disclosure legislation in general, the very existence of the Form 5500, the requirement that it be annually filed and its status as a public document no doubt encourages compliance with the statute.

(3) Implementation of ERISA by DOL

With respect to the implementation and enforcement of ERISA, from our perspective as a large defined benefit plan fund we do not believe that there is anything the DOL is not now doing that should be done. From a fiduciary standpoint, General Motors and other large plan sponsors we know of have clearly understood the concepts of fiduciary responsibility and prudent investment well before the adoption of ERISA.

Under ERISA, we read the law, endeavor to understand it, obtain legal counsel and opinion when we need expert interpretation, and otherwise seek to assure that we are complying with the statute.

The problem may not be one of where increased resources should be applied and more guidance be given, but rather where the degree of regulation can be reduced so as to avoid situations where ERISA can inhibit or even prevent common sense fiduciary conduct. As a specific example, based on my response earlier in this letter to the handling of prohibited transaction exemptions, the real solution may not be to commit additional resources to handling exemptions, but rather to obviate the need for frequent applications, at least for large sponsors, by instituting class exemptions or by changing the statute.

Finally, with respect to this area of comment, while less rather than more regulation may be better for the funds already subject to ERISA, it would seem that the arena of public funds would be fertile ground for some form of ERISA-like regulation, oversight or standards. In other words, one might question why would one endeavor to fix a system which isn't broken and works well when there may be a related area in need of repair?

(4) Conflicts of interest for some ERISA fiduciaries

In voting stock held by pension plans and in making investment decisions on behalf of the plans, it appears that some fiduciaries have, as you described it, "faced" conflicts of interest. As an example, some money managers have probably faced potential conflicts of interest when the managements of companies contact them to attempt to convince them to support management's position in a proxy fight or hostile takeover and have endeavored to leverage another relationship with the manager (other than ownership) to achieve that support. As you are probably aware, there exists a fair amount of anecdotal information which supports the thesis that fiduciaries face conflicts.

While ideally a fiduciary should be uninfluenced by any concerns other than those of his fiduciary responsibility, the situation would probably be best aided by attempting to lessen the existence of conflicts. In this regard, I believe that it may be possible to develop certain procedures or to modify the existing structures so as to reduce the potential for such conflict situations. We have listened with interest to the proposals of Bob Monks (that an organization be set up to which institutional investors could delegate proxy voting) and to the suggestions made by other persons that a rigorous regulation or law be established which would make the threat of termination of a manager, or the threat of other punitive actions if the manager did not vote with management, illegal and punishable actions. Some aspects of each of these suggestions could possibly have merit whereas other aspects are troubling or unworkable.

We have not yet developed a solution to these matters, and therefore are continuing to consider them. In any case, we have pointed out to our investment managers that we consider proxy voting to be an important part of their responsibilities, that we expect them to vote proxies carefully and in accordance with their responsibilities under ERISA, and that we understand that this may lead to votes against a company's management while the investment manager continues to hold the stock. To the best of our knowledge, our managers are exercising their responsibilities properly.

(5) Policies/Procedures to resolve conflict of interest problems

A fiduciary responsible for voting proxies currently has a clear and explicit charge which should enable him to resolve conflict of interest situations -- that is, the requirement under ERISA that the funds be managed solely in the interests of the plan's participants and beneficiaries. This is not to say that two fiduciaries, voting on the same issue and subject to the same external pressures, may not arrive at different conclusions and cast opposing votes on the issue -- we recognize that thoughtful fiduciaries will at times arrive at different conclusions.

As a pension plan sponsor, it is our belief, based upon discussions my staff has had with the managers of our pension assets, that these managers examine proxy issues thoughtfully, evaluate them and vote so as to maximize the return of the plan in the interest of the plan's participants and beneficiaries. We have obtained from many of our managers their written proxy voting procedures and the guidelines which they have developed over time. We have found that many of these organizations have (as GM has done in establishing its committee which votes proxies for companies in the portfolios managed internally) structured the proxy voting process so as to place the responsibility for evaluating the proxies upon a heterogenous group of individuals, typically investment professionals, who are involved in, or closely allied to, the actual investment process. Moreover, this group is frequently comprised of individuals such as senior portfolio managers and security analysts who have positions of sufficient responsibility to make informed and intelligent judgments but are far enough removed from the top management of the organization to be insulated effectively from most of the pressures which could be exerted by other companies.

(6) Use of pension funds in corporate takeovers:

This question must be addressed from two standpoints -- as a plan sponsor and as an investment manager of equity assets of the pension fund.

We believe that pension assets should not be employed by a plan sponsor either defensively or offensively in corporate takeovers. This use appears to us to be employing pension assets for corporate purposes, not solely in the interests of plan participants or beneficiaries.

Looking at takeovers of other companies (i.e., takeovers which do not involve the plan sponsor), as these takeovers often bring about an increase in the price of the takeover target's stock, we believe that the investment managers should examine each case individually, and based solely upon the investment implications of the proposals, from both short and longer term viewpoints, decide whether to support or vote against a proposed takeover.

Following these procedures would, we believe, protect the interests of the plan participants and beneficiaries.

* * * * *

As you requested, this is a summary of the General Motors pension plans:

Assets: somewhat in excess of $23 billion.
These are invested in fixed income securities, equities, the general accounts of insurance companies, real estate, venture capital and other specialized investments.

Participants (all data are as of most recently filed report 5500 for plan year ending 9/30/84).

Active participants

Hourly	Salaried	Total
443,072	137,066	580,138

Retired or separated participants receiving benefits

Hourly	Salaried	Total
167,644	57,238	224,882

Retired or separated participants entitled to future benefits

Hourly	Salaried	Total
18,045	10,548	28,593

Deceased participants whose beneficiaries are receiving or are entitled to receive benefits

	Hourly	Salaried	Total
	32,162	11,121	43,283
Total	660,923	215,973	876,896

Investment Decisions:

Broad policy is set by the Named Fiduciary of the plans -- the Finance Committee of the General Motors Board of Directors.

The Pension Investment Committee has been delegated certain of the more frequent investment decisions (for example, allocation of funds among different asset classes within broad guidelines established by the Finance Committee, selection of investment managers and allocation of funds among managers).

The greater part of our assets are managed by external investment managers; in 1984, we began managing a portion of the funds in-house using GM employes.

Monitoring investment performance:

> The individual managers supply us with monthly performance data. Quarterly we receive from our consultants detailed comprehensive reports which are prepared from audited data. These quarterly performance data are analyzed by our staff and reported to the Pension Investment Committee. The monthly data are tracked by the staff and any anomalies are detected by them.

Proxy voting:

> All proxies for equities purchased by external money managers are voted by those managers, based on the rationale that they are best equipped to make an informed judgment on the investment implications of a proxy issue for stocks that they own.
>
> Proxies for equities purchased by GM's in-house investment group are voted by a proxy voting committee comprised of members of my staff and in whose ordinary deliberations neither I nor any higher person in GM management participates.

I would add two final observations:

First, the private pension system in the U.S. is functioning well. To the extent that the flexibility of an employer is diminished through additional regulation, more companies may decide not to provide pension plans. Perhaps rather than increasing the regulatory and disclosure burden, it would be more effective to stiffen the penalties for substantive violations.

Secondly, and this relates to the first, the extent that the requirements of ERISA have been perceived to be onerous has been one major factor driving plan sponsors to move from defined benefit to defined contribution plan structures -- thus shifting the entire investment risk onto the employe. I believe this risk transference is a result that the legislative fathers of ERISA surely did not have in mind when they adopted the statute a decade ago.

Again, Senator Cohen, we appreciate this opportunity to discuss these issues.

Sincerely,

W. G. Binns, Jr.